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STRUCTURING MANAGEMENT INCENTIVE SCHEMES IN PRIVATE EQUITY PORTFOLIO COMPANIES

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ABSTRACT
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PURPOSE OF THE STUDY

The objective of the thesis is to study how management incentives are structured in private equity portfolio companies. Typically, the management acquires an equity stake in the company alongside the financial sponsor and, consequently, the incentive schemes are called management ownership programs. Given the paucity of previous research in this area, the primary purpose of the study is to provide a broad overview of the programs. More specifically, the intention is to investigate what kind of instruments and technical structures are employed in the industry.

DATA AND METHODS

Due to the private nature of the industry, no public database on management ownership programs is available. The data in this study comprises of three different sets which were collected by the author. The key terms of management ownership programs are explained with the help of a sample term sheet received from a German transaction law firm. Comparative quantitative analysis on the key elements of the programs is conducted using a unique data set on 29 European buyouts completed between 2001 and 2004. The data was originally compiled by a consulting firm that advised on the ownership programs of the transactions. The methods employed include t-tests, a bootstrap, a Wilcoxon rank sum test and linear regressions.

For the qualitative analysis five management participation agreements and a presentation to the management from one transaction were scrutinized. Based on the transaction documentation and explorative interviews with various experts, a questionnaire covering the central aspects of management ownership programs was composed. Using the questionnaire 15 external advisors and six fund professionals were interviewed.

RESULTS

The main finding of this thesis is that private equity firms tend to apply similar management ownership program structures, but there are significant regional differences between European and U.S. funds. European funds always require the management to bear considerable downside risk and view direct equity investments as the best way of aligning interests, whereas American houses typically grant options or non-recourse loans to the management. The tax treatment of instruments and the feasibility of vesting conditions are primary drivers affecting structuring choices. In all transactions, the management is offered substantial upside potential. However, in secondary buyouts the return profiles of the management and sponsor are usually closer to each other because of the higher investments by the management.

KEYWORDS

Private equity, management ownership program, incentives, leveraged buyout

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TUTKIMUKSEN TARKOITUS

Tämän tutkielman tavoitteena on tutkia johdon kannustimien strukturointia private equity -sijoittajien kohdeyrityksissä. Tyypillisesti johto sijoittaa yrityksen omaan pääomaan yhdessä pääomasijoittajan kanssa ja näin ollen kannustinjärjestelmiä kutsutaan johdon omistusohjelmiksi. Koska aihealuetta on tutkittu aiemmin vain vähän, tutkielman ensisijainen tarkoitus on tarjota laaja-alainen yleiskatsaus ohjelmista. Ennen kaikkea aikomus on selvittää, minkälaisia instrumentteja ja teknisiä rakenteita toimialalla käytetään.

AINEISTO JA MENETELMÄT

Alan yksityisen luonteen johdosta minkäänlaista julkista tietokantaa johdon omistusohjelmista ei ole olemassa. Tutkimuksen aineisto on kerätty kolmesta eri tietolähteestä kirjoittajan toimesta. Omistusohjelmien keskeiset käsitteet käydään läpi saksalaiselta yritysjärjestelyihin erikoistuneelta lakitoimistolta saadun sopimusmallin avulla. Ohjelmien keskeisiin tekijöihin kohdistuva vertaileva kvantitatiivinen analyysi suoritetaan hyödyntämällä uniikkia aineistoa, joka kattaa 29 eurooppalaista yritysostoa vuosilta 2001–2004. Aineiston kokosi alun perin eräs konsulttiyritys, joka toimi kauppojen omistusohjelmissa neuvonantajana. Tutkimusmenetelminä käytetään t-testejä, bootstrappia, Wilcoxon rank sum -testiä ja lineaarisia regressioita.

Kvalitatiivista analyysia varten perehdyttiin viiden omistusohjelman sopimuksiin sekä yhden ohjelman osalta esitykseen johdolle. Näiden asiakirjojen ja vapaamuotoisten asiantuntijahaastatteluiden pohjalta laadittiin kyselylomake, joka kattaa johdon omistusohjelmien tärkeimmät ominaisuudet. Lomakkeen avulla haastateltiin 15 ulkopuolista asiantuntijaa sekä kuutta pääomasijoitusammattilaista.

TULOKSET

Tutkielman keskeisin havainto on, että pääomasijoitusyhtiöillä on tapana käyttää samantyyppisiä rakenteita johdon omistusohjelmissaan, mutta selviä alueellisia eroja löytyy eurooppalaisten ja amerikkalaisten rahastojen väliltä. Eurooppalaiset rahastot edellyttävät johdolta aina merkittävää riskinottoa ja kokevat suorat oman pääoman sijoitukset parhaaksi tavaksi aikaansaada yhteiset intressit, kun taas amerikkalaiset sijoittajat yleensä myöntävät optioita tai rahoittavat johdon sijoituksia rajoitetuin takaisinmaksuehdoin. Instrumenttien verokohtelu ja omistusoikeuden siirtymisehtojen käyttökelpoisuus kussakin maassa vaikuttavat huomattavasti strukturointiratkaisuihin. Johdolle tarjotaan aina mahdollisuus korkeisiin tuottoihin. Secondary-kaupoissa johdon ja rahoittajan tuottoprofiilit ovat kuitenkin tyypillisesti samankaltaisempia johdon suurempien sijoitusten vuoksi.

AVAINSANAT

Pääomasijoittaminen, johdon omistusohjelma, kannustimet, velkarahoitteinen yritysosto

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1 Introduction

To the author's best knowledge, no academic research has been done in the area of management incentive schemes in the private equity industry. This is presumably a consequence of the great difficulties in attaining reliable data and hence the number of relevant studies is fairly limited. Private equity, as the name suggests, is largely exempt from public disclosure requirements (Kaplan and Schoar 2005, 1791-1823). Some of the firms' competitive advantage might well stem from structuring more attractive incentive schemes to buyout managements than others. The confidentiality of the programs and the resulting payoffs are considered a significant factor attributing to the recent success story of the industry as a whole. The management typically co-invests in the portfolio company alongside the financial sponsor and thus the incentive schemes are called management ownership, participation or equity programs.

The purpose of the thesis is to narrow the gap in the field of academic studies on private equity by scrutinizing the structuring of management participation programs in leveraged buyouts. More specifically, my intention is to investigate whether there are major differences in the ways in which private equity firms structure incentive schemes. A central dimension to the research question is to analyze what kind of instruments and technical structures are used in management ownership programs. Due to the limited number of transactions on which data could be attained, the reaching of statistical significance in the tests will be difficult to achieve. On the other hand, the purpose of the study is not to examine the relationship between different structure choices and their influence on incentives, but rather offer a broad overview of the programs and highlight what details play a critical role when management incentives are set in private equity portfolio companies.

In public companies, there are frequently compensation arrangements that do not serve the shareholders' interest. Defects in the underlying governance structure enable executives to exert considerable influence over their boards. The absence of effective arm's-length dealing under today's system of corporate governance – not temporary mistakes or lapses of judgment – has been the primary source of problematic compensation arrangements. (Bebchuk and Fried 2004, 278)

Bebchuk and Fried (2004) suggest reforms that would reduce the boards' insulation from shareholders. According to them, directors must be made not only more independent of insiders but also more dependent on shareholders. They argue that the pay-setting process in publicly traded companies has strayed far from the arm's-length model – bargaining between the executives attempting to get the best possible deal for themselves and boards seeking to get the best possible deal for shareholders – that has been a basis for corporate law rules and economic studies. In private equity, the negotiations on executive remuneration are notably more straightforward as they are normally held directly between the management team and the financial investor just prior to the closing of the transaction.

A further threat to efficient compensation programs on the public side is presented by common attempts of camouflaging the level and performance insensitivity of executive compensation. This usually happens at the cost of managers' incentives and, in turn, company performance – imposing even greater costs on shareholders. In Bebchuk and Fried's (2004) view, the reduction in shareholder value caused by these inefficiencies – rather than that caused by excessive managerial pay – could well be the biggest cost arising from managerial influence over compensation.

Executive compensation has long attracted much attention from investors, financial economists, regulators, the media, and the public at large. Unfortunately, there have also been fraudulent cases such as option backdating discovered, nevertheless, most of the debate has concerned perfectly legal remuneration arrangements. Indeed, Murphy (1999) calculated that the dramatic growth in executive pay during the 1990s was still outpaced by the increase in the volume of research papers on the subject.

The rise in executive pay has been the subject of much public criticism and private equity firms might have gained competitive advantage from their ability to keep their management team members protected from this kind of social costs. Payoff levels similar to Fortum CEO Mikael Lilius' recent windfalls are not uncommon in the private equity industry, however, the public never gets to hear about their occurrence. In the same breath it must be noted that the management equity programs in general require significant investments from the participants at the time of the buyout and the managers, consequently, stand the risk of losing their invested capital which usually represents one to two annual salaries. Option programs that provide pure upside are conjectured to be rare in private equity because making the

management co-investors with the financial sponsor is assumed the most effective way of aligning their interests.

Buyouts bring their own, particular demands for the management. For a team to operate independently of a parent company, to anticipate the rewards that successful entrepreneurship can bring and to expose its performance to the unforgiving light of the investment community will represent opportunity – and personal risk – to a degree rarely achievable in the corporate world (Sharp 2003, 119). The private equity investor wants to secure the management's cooperation and its know-how for the whole investment period. Thus, a significant equity stake of up to 15% is generally reserved for the management. In a typical buy-out-structure, the investor will not invest directly but only indirectly through an acquisition vehicle (NewCo) into the target company. Only the main decision makers (key people) of the target should be offerees of the management ownership program (MOP); otherwise, the effects of the program might be diluted through the large quantity of individuals connected. To assure that the management's interests get well aligned with the financial investor's ones, the sponsor will want to know about possible sell-side bonuses or other management proceeds that are connected to the success or value of the sale. The financial buyer usually tries to oblige the management to invest equal to this amount deducted by taxes and other costs into the management equity program in order to make sure that the managers bear significant personal risk.

The purchase or the subscription price for the management usually corresponds to the price paid by the financial investor for the equity capital. Due to option-like structures, it might sometimes seem that the management is paying a higher price for their shares, however, the possible difference stems from the higher upside potential that their investment carries. Generally, the purchase price becomes due and payable immediately upon the transfer of the respective management equity and hence the participants are often dependent on external financing. Under the common provision of a management ownership program, the management must provide for warranties to the financial sponsor, such as that the information contained in the due diligence reports on the target that were prepared by the advisors to the buyer is correct and complete. Another common demand is the guarantee of having no knowledge of any fact which might have a negative impact on the business development and projections in the collaboratively coordinated business plan of the target

(Hohaus and Inhester 2003). Any liability is usually restricted to an amount equal to the equity interest acquired by the management.

Both parties wish to mutually participate in the target's expected increase in value. Accordingly, a disposal of the equity stake by either party is generally not possible prior to a joint exit through a trade sale, an IPO, secondary sale etc. The allocation of exit proceeds follows the distribution of shareholding in the NewCo. Regardless of which type of structure is used, a steep upside is normally offered to the management to motivate them to their best possible performance. For instance, when using a classic structure based on disproportionate splits of common equity and shareholder loans between the management and the private equity investor, typically only the financial sponsor subscribes to shareholder loans while the management invests solely in common equity. The ordinary shares have little value to begin with as the shareholder loans make up the bulk of the initial equity value. Consequently, the management is able to buy a noticeable stake of 5 to 10 percent in common equity despite their limited funds. The ordinary shares are subordinate to the shareholder loans which carry a fixed interest rate of around 10%. Thus, common equity will only have value when the company is exited if all the shareholder loans including accrued interest have been fully repaid. This results in an option-like return profile for the MOP participants since after the hurdle rate of the shareholder loans has been surpassed all of the value increase will feed to common equity where they have a disproportionately high holding. Therefore, the successful implementation of a business plan generally leads to considerably higher return multiples for the management than the private equity investor who gets a fixed return on the bulk of its funds. This classic management ownership program structure and other alternatives will be described and analyzed in more detail later in the thesis.

The remainder of the thesis is organized in the following way. Chapter 2 reviews the existing literature on management incentive schemes and describes how leveraged buyouts act as incentive alignment vehicles. Furthermore, Chapter 2 provides the reader with general information on private equity and management ownership programs. Chapter 3 discusses and motivates the hypothesis and primary questions of interest of the thesis. The data and methods are described in Chapter 4, and the analysis of the quantitative and qualitative data follows in Chapter 5. Chapter 6 discusses the main findings and concludes.

2 Literature Review

2.1 Management Incentive Schemes in General

The need for management incentive schemes fundamentally stems from the so-called agency problem. The separation of ownership and control leads to a situation where a company's managers act as agents of its shareholders. The principals (the shareholders) cannot directly ensure that the agents (the managers) will always act in the principals' best interest. As a result, the manager-agents, whose interests do not fully overlap those of the shareholder-principals, may deviate from the best course of action for shareholders – referred to as the agency problem (Jensen and Meckling 1976, 305-360). Incentive schemes are designed to fix this dilemma by aligning the managers' incentives with the shareholders' as closely as possible.

It is surprising how sophisticated and similar to the contemporary management participation programs in private equity the original incentive schemes of Du Pont and General Motors in the beginning of the 1920s actually were. These firms were among the first to confront the acute need to align the interest of management with shareholders since it was not feasible for managers to own a significant portion of the sizable firms. GM and Du Pont lent money to managers so that they could purchase company stock at market prices. Managers paid market interest rates on such loans and the plans lasted from seven to ten years. The historic schemes provided incentives that were large relative to the salaries and wealth of the participating executives and presented a non-trivial portion of the firm (up to 3-4% of common stock) (Holden 2005, 135-144).

Consequently, the schemes provided executives with equity incentives that had both downside and upside risk, were relatively long-term in nature and placed emphasis on operating performance as well as stock price. To be frank, it is intriguing how close those schemes are in nature with the management equity programs that private equity funds employ nowadays – even the investment levels considered to pose adequate risk for the participants are of similar magnitude, representing one to two annual salaries. Considering the amount of criticism that the modern stock-option plans of public companies have met, it is rather

puzzling why they have become so popular while at the same time the type of schemes that were put in practice in the early days have basically faded-out after the mid-1950s.

Currently, most public firm executive pay packages contain four basic components: a base salary, an annual bonus tied to accounting performance, stock options, and long-term incentive plans (including restricted stock plans and multi-year accounting based performance plans) (Murphy 1999). The traditional private equity model of remunerating executives with relatively modest annual cash compensation and benefits but significant equity stakes is quite different. The pay packages are notably simpler as they usually do not include any long-term incentive plans other than the exit-bound management participation program. The numerous incentive scheme specialists that I interviewed during the process of writing this thesis shared the view of direct stock ownership being the ideal mechanism for aligning interests, however, usually too expensive and providing inadequate upside in public companies if not coupled with option-like characteristics. Some companies have even ceased to grant stock options as these are deemed unattractive by executives. Too high expectations have been factored into the prevailing stock price which, in turn, has rendered significant upside movements unlikely. Microsoft can be taken as a prime example.

The main drawback with equity based pay, regardless whether in form of straight equity or options, is that company executives generally place a much lower value on their holdings than an outside investor would. Primary reasons behind this are the poor diversification of the managers with a giant share of their wealth bound to the same company and the illiquidity of their investment (Murphy 1999). CEO pay has also attracted a lot of controversy from the early 1990s onwards. Jensen and Murphy (Jensen and Murphy 1990, 225-264) predicted that the populist attack on CEO pay would lead to both lower pay levels and lower pay-performance sensitivities. However, both the level of CEO pay and the sensitivity of CEO wealth to stock price performance increased substantially during the 1990s despite the strong criticism (Murphy 1999).

Nevertheless, there is ample evidence that politics and public perception play an important role in determining the structure and level of executive compensation. Factors found to have influence include, for instance, years of union-negotiations (DeAngelo and DeAngelo 1991, 3-43) and political pressures of different natures (Dial and Murphy 1995, 261-314; Joskow, Rose, and Wolfram 1996, 165-182). The disclosure requirements on executive pay have been

sharpening consistently since the introduction of the Sarbanes-Oxley Act. From the beginning of 2007, the Securities and Exchange Commission ("SEC") has required public U.S. companies to file more comprehensive and understandable information regarding their executive compensation programs via the new Executive Compensation and Related Person Disclosure rules. The definition of total compensation is changing – with the new disclosure rules it should be easier to quantify, understand and compare the total pay a company's named executive officers receive annually, which, in addition to base salary and bonus as previously required, will include the value of equity compensation using a common approach (FAS 123R), annual increases in actuarial pension values and supplemental plans, above-market earnings on deferred compensation, and all other compensation in excess of $10,000 (Joyce 2006).

The interviewed practitioners had somewhat dispersed perceptions of the extent to which negative publicity poses a threat to efficient incentive schemes. Some thought that in the end the shareholders opinion counts and usually they are quite well-off themselves if the executives receive disproportionate payoffs. Yet, some American respondents considered the ever sharpening regulation an even more problematic issue for public firms while private equity houses are enjoying more freedoms similar to hedge funds. Altogether, there was a consensus about the private equity firms being more nimble with their incentive schemes and, on average, simply rewarding the executives more generously. Former success stories and the huge upside potential attract top talent from leading traditional firms. In the fall of 2006, the New York Times reported about General Electric's vice chairman David L. Calhoun becoming chairman and chief executive of the Dutch VNU Group held by a private equity consortium. Yet, no details of his pay package which can be assumed utmost rewarding were disclosed (Deutsch 2006).

The buyout is becoming almost a rite of passage for senior managers, particularly in regions with considerable LBO activity. For instance, in the UK many of the highest profile commercial names have at least one successful transaction in their CVs. In most cases these have provided not only a basis of significant personal wealth, but also the experience of operating independently and dealing directly with the investment community. In this respect the buyout does represent an aspect of career opportunity, however, it only works if the operational skills needed are clearly and demonstrably in place from the beginning (Sharp 2003, 119).

2.2 *Challenges in Designing Equity-Based Pay Plans*

If you compare modern incentive schemes that link executive compensation to the performance of company stock with their ancestors you intuitively think that they would have a lot to learn from the latter. A fundamental issue with stock options is that they are worth nothing at all if the stock price doesn't rise above the exercise level, which may encourage excessive risk-taking (Hall and Knox 2004, 365-412; Holmstrom and Milgrom 1987, 303-328). In addition to this, options are plagued with the following characteristics. Out-of-the-money options that are far from the exercise price may provide little incentives. If not dividend adjusted, options can encourage over-retention of earnings (Hall and Murphy 2003, 49-70). The vesting periods of stock options are often relatively short, causing management to focus on short-term rather than long-run performance. Excessive concern over current stock price can motivate managers to use observable investment decisions to manipulate the market's inferences about the firm, of which the result can be overinvestment or underinvestment (Bizjak, Brickley, and Coles 1993, 349-372). On the other hand, options can and should be linked to peer group performance such as industry indexes, which enables the rewarding of well-performing managers even in bear markets – this is considerably more difficult to achieve with straight equity.

Hall (2003, 21) lists six fundamental challenges in designing equity-based pay plans that correctly align managerial incentives with the pursuit of shareholder value. Next, I will discuss how management equity programs in leveraged buyouts (LBOs) stand in relation to these challenges and whether they possibly mitigate some of the issues.

Mismatched Time Horizons

In private equity transactions, the time horizons of the management and the shareholders are almost perfectly aligned since all groups payoffs are only realized through and at the point of a successful exit.

Gaming

There is little room for short-term accounting tricks or similar kinds of questionable behavior since the buyer candidates will without a doubt carry through a thorough due

diligence prior to closing a transaction. Normally, the sell-side is also liable for the information contained in the information memorandum used in the sale process.

The Value-Cost "Wedge"

The term could be defined as the potentially significant disparity between the real cost of an equity grant and the value of that grant to the executive. The risk-adjusted executive value of the management participation is naturally lower for the undiversified individual manager than for the diversified fund and its well-diversified limited partners. This is a common phenomenon for all equity based instruments and needs to be taken into consideration by the boards and shareholders while structuring pay packages.

The Leverage-Fragility Tradeoff

Partly offsetting the value-cost inefficiency of options is the fact that they are a leveraged incentive device and, consequently, companies can grant employees more stock options than shares for the same cost to the company. But option incentives are fragile, as far out-of-the-money options tend to lose their power both to motivate and to retain executives. Also in private equity the management equity is typically levered into both directions, however, usually only large declines in company value make the management holdings totally worthless. In case the managers invested private funds into the program they have an incentive to try their best even if some loss is unavoidable.

Aligning Risk-Taking Incentives

The materialization of the management's payoffs is conditional on a successful exit which, in turn, normally requires the achievement of the business plan's targets. The upside returns from exceeding these targets generally feed at levered levels to the management and hence induce them to strong risk-taking. On the other hand, the management that has invested into common equity with borrowed money is usually required to carry a disproportionately high share of the losses if the equity capital cannot be reclaimed, which balances out reckless risk-taking.

Avoiding Excessive Compensation

This does not represent a problem since excessive compensation to the management is always connected with very high returns to the financial investor as well. The interviewed incentive scheme specialists saw the considerable upside of the management equity

programs as the greatest competitive advantage with respect to public companies. A common view in the industry is that portfolio company turn-around executives should be able to stop working after a lucrative exit if desired. At the same time one should bear in mind that the participants stand the risk of losing a fortune. In addition to this, public criticism of the amount of compensation is not to be expected – a feature that is becoming increasingly important to top executives.

Holden (2005, 135-144) actually concludes his paper by noting that the move to today's stock option plans is somewhat puzzling since the old schemes that are similar to management ownership programs in private equity seem to entail so many benefits. A holding company structure is sometimes also used on the public side to motivate crucial executives in turn-around cases, but many practitioners perceived direct equity as too costly and limiting flexibility in public firms as adding new participants to the existing scheme is quite complicated.

2.3 Leveraged Buyouts as Incentive Alignment Vehicles

The leveraged buyout boom of the 1980s could be viewed as a response to corporate managers often not making value-maximizing decisions. In an MBO, a company or business unit is acquired by a group of managers and financiers who end up owning the equity in the new organization. In today's private equity transactions the management practically always invests alongside the financial investor, and consequently, LBOs and MBOs will be used as synonyms in this thesis. Most of the capital required to finance the acquisition is raised as debt rather than equity. Many financial contracting theories predict that the investors should hold a debt-like claim. The security design theories based on classical principal agent theory show that giving investors a senior claim is useful for incentive purposes as it makes the manager's residual claim more sensitive to performance (Innes 1990, 45-67). Apart from seniority, however, another important characteristic of debt is the ability to take control and liquidate the firm when performance is bad (Kaplan and Strömberg 2003, 281-315).

In leveraged buyouts the management faces both aforementioned pressures. On one hand, the participating managers' investments usually increase in value only if the company value rises

significantly, whereas minor appreciations generally go to service the fixed return preferred instruments principally subscribed to by the financial investor. On the other hand, in case that the company ends up in financial distress and violates its debt covenants, the managers are very unlikely to recover any of their equity investments. Additionally, there are severe penalties for underperformance as managers' shares are typically vested over time and if they are fired they lose any unvested portion of their claim. All in all, there are very high incentives for the managers to perform as well as they can so that the company is able to pay off debt while simultaneously increasing in value.

In private equity, a vital part of the transaction is to pick the right management team and to immediately align their incentives with the financial sponsor's since due to the high debt burden there is little room for inefficiency or error. Thus, direct equity participations are most often used and, consequently, managers and private equity firms share a strong interest in making the venture a success because their equity interests are subordinate to other claims. Success requires implementation of changes to avoid investments in low return projects, to generate cash for debt service and to increase the value of equity (Jensen 1986, 323).

Several researchers have found operating performance improvements and value increases in companies following leveraged buyouts (Kaplan 1989, 217-254; Smith 1990, 143-164). Kaplan discovered increases in the operating income before depreciation and net cash flows as well as reductions in capital expenditures in the 48 large management buyouts between 1980 and 1986 that he studied. According to his results, the main driver behind the beneficial development of the companies appears to be improved managerial incentives rather than wealth transfers from employees or superior managerial information. Thus, there is plenty of reason to scrutinize what kind of management participation programs are used in leveraged buyouts and in which ways they align the incentives of the managers with the shareholders'.

2.4 Management Participation Programs in Private Equity

2.4.1 Private Equity in General

Leveraged buyout funds are typically organized as private limited partnerships with the LBO fund managers acting as general partners. These funds raise capital from larger financial institutions such as pension funds and endowments (referred to as limited partners) and they invest in diversified portfolios of companies. Private equity firms usually raise multiple funds over time, each having a finite life of about ten years. General partners are active in the operation of the companies in which they invest – typically assuming control of the board of directors and often bringing in knowledge in form of industrial advisors. In general, fund managers are skilled and active monitors of the decisions being made by the company managers. Improvements in operating performance after leveraged buyouts are not solely attributed to strengthened incentives of the managers but also to changes in the monitoring and governance structure of the firm (Baker and Wruck 1989, 163-190).

General partners of LBO funds typically receive 20% of the value created after a target rate of return of about 8% is exceeded as carried interest income. In addition to this, they generally receive an annual management fee of 2% of committed capital. As the fees are by no means low, the long-term success of a private equity firm is strongly dependent on keeping its investors satisfied by offering above average fund returns. The dramatic increase in the number of private equity funds over the past decade offers plenty of investment alternatives to reputable limited partners such as large pension trusts, nevertheless, investors tend to stick with the well-performing general partners of the top quartile as returns tend to persist strongly across subsequent funds of a partnership (Kaplan and Schoar 2005, 1791-1823). All in all, the industry has matured from a small alternative investment vehicle to an important asset class.

2.4.2 Business Logic in Private Equity

There is a common misperception that private equity investors only see value in rapidly growing companies. A stable, strong cash generative business can equally well generate value

increases for its equity holders simply by using surplus cash flow to repay the debt used in financing its acquisition (Sharp 2003, 119). The example in Figure 1 is to illustrate how steady value creation can lead to lucrative payoffs to the co-investing financial sponsor and the management. In this example, the private equity fund makes a four time and the management a 17 time return on its initial equity investment over the 5.3 year holding period.

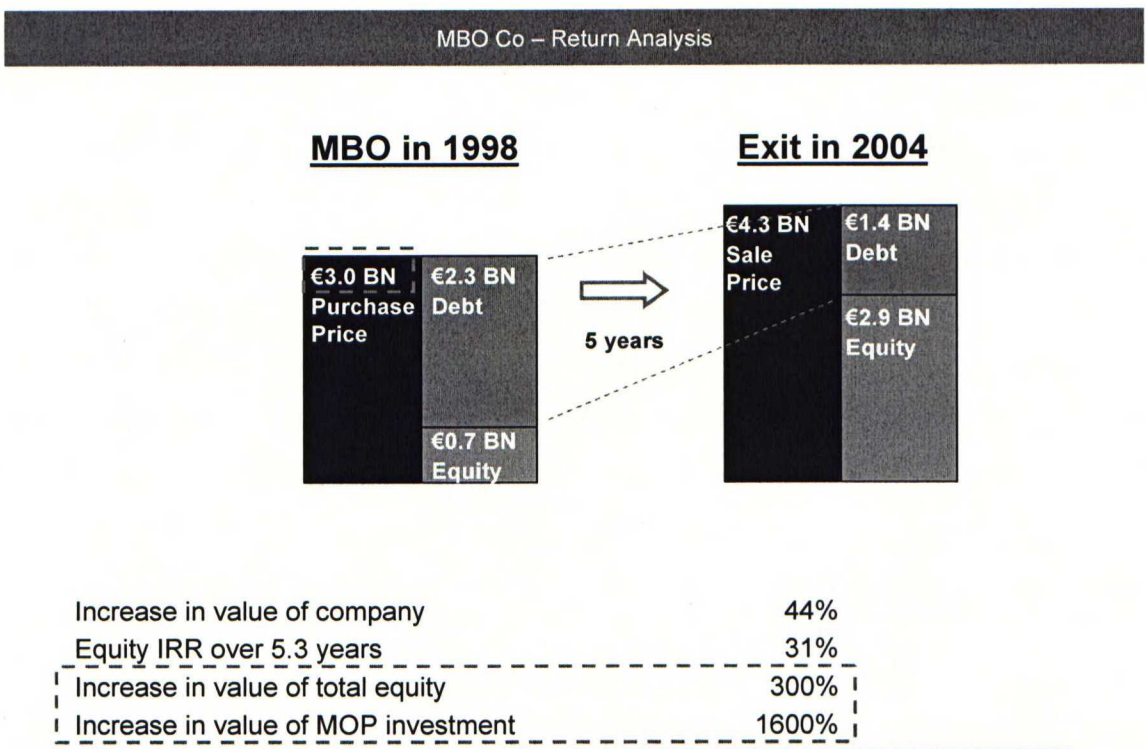

Figure 1: Illustration of Returns from a Management Buyout

The company value has increased 44 percent from 3.0 billion euros to 4.3 billion euros, representing a cumulative annual growth rate of 7.5 percent during the five-year investment period. Simultaneously, the company has repaid part of the debt from its free cash flow. The proceeds of the sale are allocated first to repaying the remaining debt and, secondly, to redeeming the cost of the private equity investment, plus interest on those funds. As a significant portion of the debt has been paid down, most of the total proceeds are assigned to equity, which leads to an internal rate of return (IRR) of 31 percent on total equity in spite of the notably lower growth in enterprise value (7.5%). The surplus is divided between the financial sponsor and the management, in line with their respective shareholdings. The arrangements leading to leveraged returns of the management such as in this case will be explained in later sections.

2.4.3 Goals of Management Participation Programs

The purpose of management participation programs in private equity is the alignment of interests between the management and the financial investor. The private equity fund has a number of companies in its portfolio and is thus significantly better diversified than the manager who has both his income and equity investment bound to the same company. During the holding period, the private equity investor is looking to increase the value of the target considerably and achieve high profits through a successful exit. Consequently, the financial investor needs to motivate the management to work hard and encourage them to higher risk-taking than what would be optimal out of their personal viewpoint. The management participation program must offer a levered upside in order to induce the managers to the level of risk-taking sought by the sponsor and provide sufficiently attractive payoffs to the management's equity contributions which are yet nominal in the overall context due to the restrictions set by each manager's private wealth. On the other hand, the private equity firm does not want to give away too much of the proceeds. The goal is that each individual's investment is large enough to represent a serious personal commitment, but not so large as to cause the level of concern that would hamper his performance (Sharp 2003, 119).

Secondary buyouts, which are in effect buyouts of buyouts, entail additional conflicts of interests as the management acts actively on both sides of the transaction. On one hand, it is in their interest as a seller to achieve as high of a transaction price as possible, on the other hand, as buyers they want to re-invest at a fair price into the next management participation program. Since they have proven to be a successful buyout management team their negotiation position is rather strong besides which they have gained experience from the first program. Because of the high proceeds that they make from the first buyout it is a difficult task for the next sponsor to find the right level of participation to embody a serious personal commitment but simultaneously not to share too large of a fraction of the exit profits with the management. Consequently, it is of great interest to compare secondary buyout management ownership programs with the ones in primary buyouts.

In contrast to industrial buyers, financial investors usually do not have additional management resources to draw on if a manager proves to be incompetent or terminates his contract during the holding period. Thus, before any buyout exhaustive screening of the

management team's capabilities is conducted and all management ownership programs require the managers to continue working for the firm in order to realize any gains. With regards to his character, the right type of manager is passionate about the business and has an ability to drive the company forward towards a successful exit. An appropriate incentive scheme must always be exit-oriented as this is the only way for the financial sponsor to realize any profits. In the end, a manager looks at what is left for him after the deduction of taxes and hence tax implications play a major role while deciding on the optimal structure. Before proceeding to the practical details in the next subsection Table 1 summarizes the general goals of management ownership programs.

Table 1: Goals of Management Ownership Programs Summarized

1 Performance incentives	- Creation of close to identical interests between management and financial sponsor - Participation dependent on performance and allocation of proceeds
2 Leverage	- High profit prospects with low initial investment
3 Stay incentive	- Negative / positive vesting - Participation dependent on time and allocation of proceeds
4 Avoidance of initial taxation	- Purchase at fair market value
5 Reduction of exit taxation	- Advantaged capital gains treatment vs. ordinary income

2.4.4 Instruments and Alternative Technical Structures

Based on what could be inferred from the literature, there are three distinct ways of structuring a management ownership program (von Braunschweig 2005, 208). The instruments and alternative technical structures will be depicted in the following sub-sections. In practice, several of them might be used in combination in the same management participation program.

2.4.4.1 Direct Participation

Structures in which the management co-invests with the financial sponsor at the time of the buyout by subscribing to a certain fraction of the equity are called direct participations. In many countries direct equity ownership carries significant tax benefits as long as the

conditions of beneficial ownership are fulfilled. Usually, tax authorities accept beneficial ownership only if the manager bears both the risk and chance that the shareholding increases or decreases in value and if the manager can exercise the administrative rights deriving from his shareholding, especially voting and pre-emption rights are of importance. The former of the features is generally greatly welcomed by private equity firms as the bearing of negative risk by the management strengthens the alignment of interests remarkably. Neither do the latter usually pose any problems since the management's equity normally represents just a minor fraction of the total equity capital. As a result of its favorable characteristics, direct equity participation is a natural choice in various situations and is thus assumed the most common way of structuring management participation programs.

Figure 2 illustrates the basic way of structuring disproportionately high upside returns in combination with increased downside risks for the management by allocating uneven proportions of common equity and shareholder loans to the management and the financial sponsor. To secure the highest commitment of the independent board members, they might be given the opportunity to participate as well, however, typically with minor stakes in unison with their level of engagement.

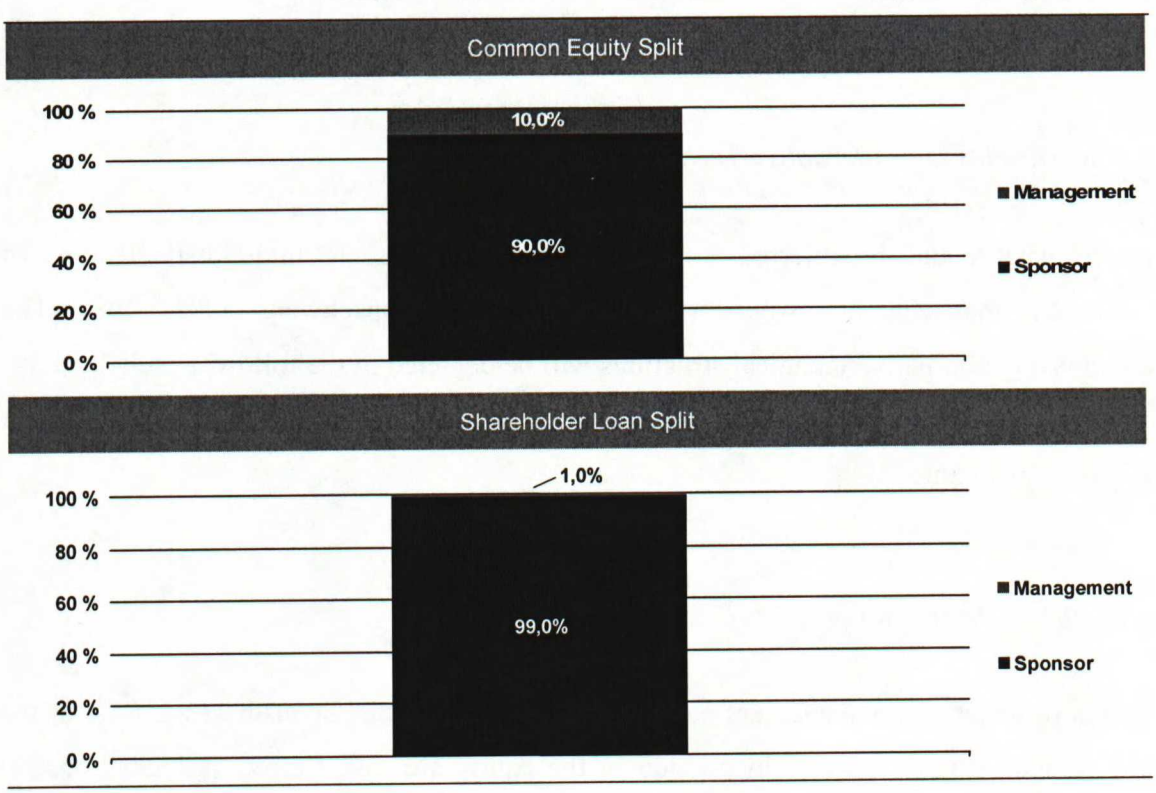

Figure 2: Setting Up a Direct Equity Participation Program

In this example, we assume that the enterprise value of the target is 500 million euros and the acquisition is financed with 400 million of debt and 100 million of equity. The debt financing is provided by banks, whereas the equity investment is made by the financial sponsor and the management. The initial equity value consists of 80 million euros in shareholder loans and 20 million euros in common equity. Thus, the management subscribes to equity worth 2 million euros and shareholder loans worth 0.8 million. The remaining 18 million and 79.2 million investments are made by the sponsor, respectively. Table 2 summarizes the equity investments by the parties.

Table 2: Summary of Equity Investments by the Sponsor and the Management
This table presents the allocation of the equity investments by the parties in millions of euros. The third and fifth column show what portion of each asset class the sponsor and management subscribe to. The split of the parties' equity investments between the two instruments can be read from the bottom rows.

	Total	Sponsor	*in %*	Management	*in %*
Shareholders Loans (12%)	80.0	79.2	*99.0%*	0.8	*1.0%*
Common Equity	20.0	18.0	*90.0%*	2.0	*10.0%*
Total Equity	**100.0**	**97.2**	***97.2%***	**2.8**	***2.8%***
Shareholders Loans as % of Total Investment		81.5%		28.6%	
Common Equity as % of Total Investment		18.5%		71.4%	

With the concurrent paying down of bank debt and the increase in company value the equity value will increase, and simultaneously the initial equity value distribution of 20% in common equity and 80% in shareholder loans will change. This happens because the shareholder loans earn a fixed 12% per annum in payment in kind (PIK) interest and in case the return on equity exceeds this rate, wealth will be transferred to common equity. The sponsor receives the 12% fixed return on the bulk of its investment whereas the management has more than two-thirds of its money in the residual common equity. As a result, it is to the management's benefit if the total equity value grows at rates higher than the yield on the shareholder loans, i.e. the IRR exceeds 12% in this case. Table 3 illustrates the allocation of equity proceeds in case of an exit in four years with an IRR of 18%.

Table 3: Allocation of Exit Proceeds - IRR Exceeds the Rate on the Shareholder Loans
This table illustrates how the equity value is distributed between the sponsor and the management. The shareholder loans including accrued interest are paid first and the remaining value is distributed between the common stock holders. The last three rows show the total proceeds to each party in comparison with their invested capital and the resulting return multiples.

EXIT IN 4 YEARS - IRR = 18%	**Total**	**Sponsor**	***in %***	**Management**	***in %***
Equity Value at Exit	193.9				
Repayment of SH Loans	125.9	124.6	*99.0%*	1.3	*1.0%*
Left for Common Equity	68.0	61.2	*90.0%*	6.8	*10.0%*
Total Proceeds		**185.8**		**8.1**	
Initial Invested Capital		97.2		2.8	
Multiple on Invested Capital		**1.9**		**2.9**	

The shareholder loans of the sponsor and management have grown to 124.6 and 1.3 million euros including accrued interest, respectively. After the repayment of the shareholder loans, 68 million euros are left for common equity, which is distributed according to the shareholding between the parties. The value of the management's ordinary shares has increased from 2.0 to 6.8 million euros, which represents a 3.4 time return on common equity. On their total equity investment they receive a lower return due to the fixed rate on the shareholder loan. Their multiple on invested capital or money multiple of 2.9 is still considerably higher than for the financial sponsor (1.9) who allocated the majority of its funds to the preferred fixed return instrument.

Naturally, this works the other way around as well and the management who holds a disproportionately high share of common equity makes losses if the hurdle rate is not surpassed. For instance, if the internal rate of return on equity is only 6% there will be hardly any value to be distributed to common equity. Consequently, the management loses basically all of its common equity and only reclaims its 0.8 million in shareholder loans plus accrued interest. The financial sponsor is significantly better off with more than four-fifths of its funds invested in the fixed return instrument and in spite of the lost common equity is able to achieve a money multiple of 1.3, which is presented in Table 4.

Table 4: Allocation of Exit Proceeds - IRR is Below the Rate on the Shareholder Loans
This table illustrates how the equity value is distributed between the sponsor and the management. The shareholder loans including accrued interest are paid first and the remaining value is distributed between the common stock holders. The last three rows show the total proceeds to each party in comparison with their invested capital and the resulting return multiples.

EXIT IN 4 YEARS - IRR = 6%	Total	Sponsor	*in %*	Management	*in %*
Equity Value at Exit	126.2				
Repayment of SH Loans	125.9	124.6	*99.0%*	1.3	*1.0%*
Left for Common Equity	0.4	0.3	*90.0%*	0.0	*10.0%*
Total Proceeds		**125.0**		**1.3**	
Initial Invested Capital		97.2		2.8	
Multiple on Invested Capital		**1.3**		**0.5**	

By modeling all kinds of different scenarios we can derive a whole return profile for the management and the sponsor. Figure 3 is not connected to the above example but illustrates a classic return profile structure. The management and possibly additional board members, on one hand, achieve lower returns on their equity than the financial sponsor at money multiples below 1.6 and, on the other, receive higher returns after the return on total equity measured by the overall multiple surpasses that level.

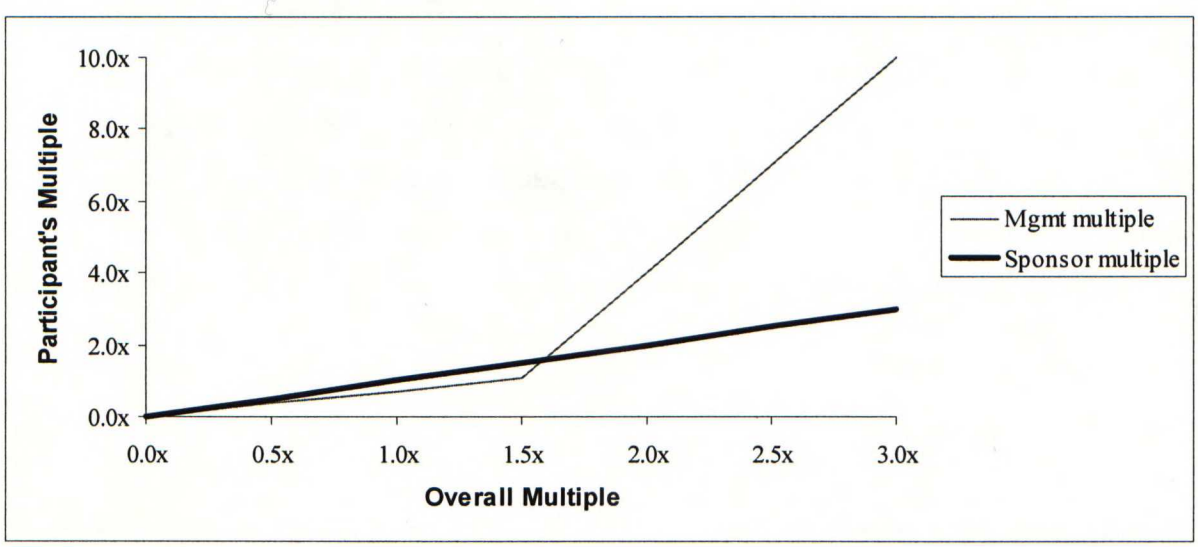

Figure 3: Return Profile Illustration - Management vs. Private Equity Investor Multiples

In this example, we hypothesize that the management and private equity investor have agreed on aiming at an exit at an overall multiple of 2.5 times money invested in the collaboratively coordinated business plan – representing the so-called the base case. This would lead to a money multiple just slightly below 2.5 for the private equity fund and around seven for the participating managers and board members. The base case is always located on the right-hand side of the point where the management starts making disproportionate returns in a return

profile graph. Thus, the management and board members are substantially awarded for achieving the target level set at the buyout stage.

The so-called envy ratio is used to measure the upside offered to the management when the base case is realized and it is defined as the management multiple divided by the sponsor multiple. Therefore, in the above example the envy ratio is 2.8 – equal to seven divided by 2.5. However, in case that the company value does not increase and the private equity investor only barely recovers its initial investment at a money multiple of one, the management and board members will only reclaim 70 percent of their original investments.

2.4.4.2 Stock options

Although stock options are the single largest component of compensation in public companies (Murphy 1999), their importance in management ownership programs is ambiguous. The main reason for this is that by using options the management is solely offered upside gains without any risk on the negative side. Thus, it is assumed that they might well be coupled with other instruments to offer additional upside incentives but rarely compose a whole program as such. In order to offer stay incentives, option programs should have gradual vesting schemes so that unvested options can be forfeited if the manager is to leave. On the other hand, an accelerated vesting scheme should ensure that managers get awarded if the company is sold or listed prematurely and not all options have been vested yet.

2.4.4.3 Phantom Stock

Phantom stock, also known as "mirror" stock, is a way of granting equity ownership to employees without actually issuing shares to them. In a phantom stock plan, a company contractually agrees to reward an employee if the firm's stock appreciates over a given period (Ray 2001, 31). In private equity transactions, phantom stock can be used to compensate the management at the point of exit analogously as if they had participated with a certain amount of equity in the buyout. As the awards are determined solely based on mutually agreed mathematical formulas, the theoretical equity participation might be scaled or fully conditional on achieving certain performance targets.

2.4.4.4 Summary of Instruments and Alternatives Technical Structures

Table 5 offers a summary of the structuring alternatives discussed in this section. The comparison is based on the different goals of incentives schemes introduced in the previous section. Negative vesting means that the whole amount of equity is granted from the beginning, however, if a manager is to leave the company before the exit, at least part of his equity will be called by the financial sponsor. The price paid depends on the reason for leaving and the different conditions are typically identified in the so-called leaver schemes which will be discussed later. Positive vesting is identical to the typical convention on the public side.

Table 5: The Alternative Structures in Relation to the Goals of the Programs

Goals	Direct participation	Stock options	Phantom stock
1 Performance incentives	Appreciation potential of the participation purchased with private capital	Possibility of exercise only if targets have been met; if out-of-the-money, no capital investment	Connected with performance and exit targets
2 Leverage	Relatively low capital investment with high appreciation potential	Low capital investment in case of exercise	No capital investment
3 Stay incentive	Negative vesting (buy back of shares)	Positive vesting (increase in number of options)	Connected with minimum stay in the company
4 Avoidance of initial taxation	Purchase at fair market value	Upon granting of options no taxation	No taxation
5 Reduction of exit taxation	Economic ownership of the participation is critical	Full tax liability in case of exercise	Full tax liability in case of exercise

2.4.5 Acquisition Structures

The customary use of acquisition vehicles and other subsidiaries in private equity transactions seems to be mostly driven by tax and liability issues. With help of these affiliated companies one can evade (i) the personal liability of the financial investor and the management, (ii) foreign investors can ascertain the tax-deductibility of interest payments in the country of the

target, and (iii) foreign funds avoid the liability to pay taxes in the domicile of the target (von Braunschweig 2005, 208).

Usually, the management participates at the level where the exit is foreseen, which ascertains that the returns they make are taxed as capital gains and not as dividends received from a lower level company. Otherwise, they might additionally stand the risk of having to wait for the distribution of profits from a lower level company, as the power of timing would lie in the hands of the private equity investor. Channel Island and Luxembourg based investment vehicles such as depicted in the example in Figure 4 are often employed in Europe as significant tax benefits can be attained through their utilization. The acquisition structure is always developed on a case-by-case basis by the legal advisors of the buyer to optimize the tax treatment of the instruments. Consequently, I will not elaborate on the details of this particular structure but only comment on general principles. As in Figure 4, the management typically forms a holding company (the management vehicle) and invests alongside the financial sponsor's holding company into the joint investment vehicle from which the equity flows further into the local TopCo. The senior debt and mezzanine loans are taken directly by the target and the local TopCo to limit the liabilities of the equity investors and to secure the seniority of the lenders. Acquisition structures should always serve various kinds of exits and recapitalizations.

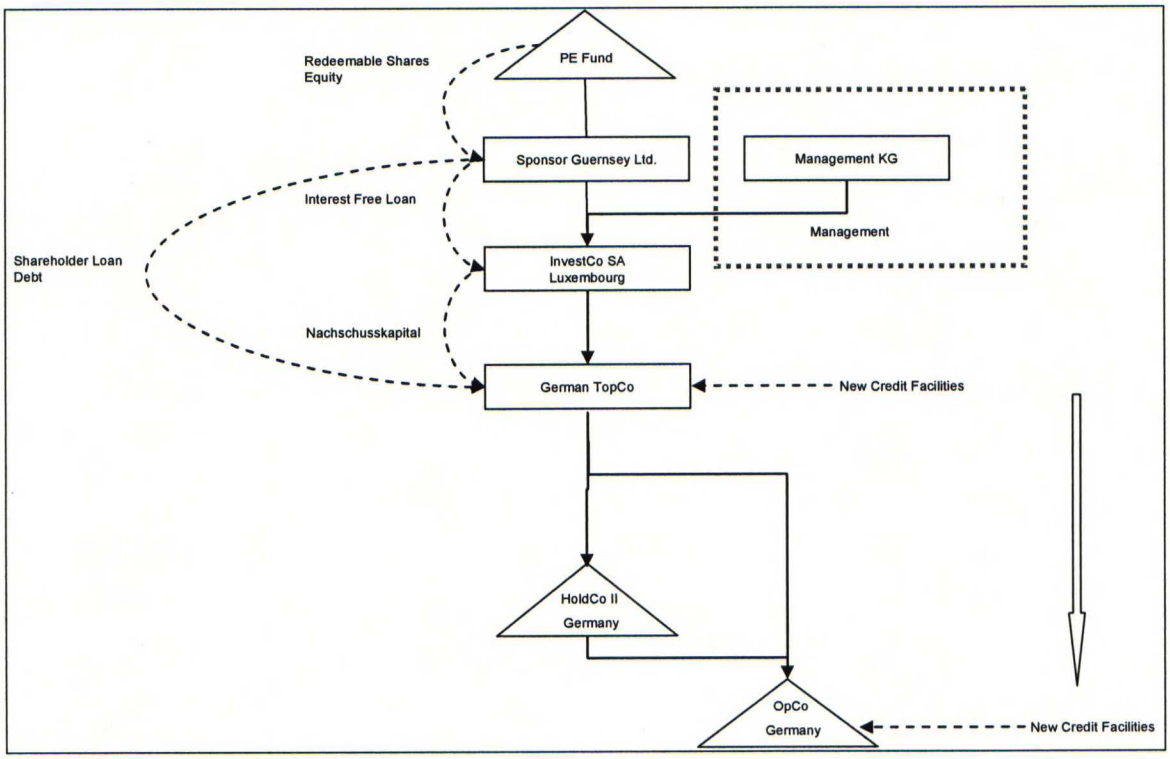

Figure 4: Example of a Common Acquisition Structure

3 Hypotheses and Primary Questions of Interest

In this chapter, the primary questions of interest and hypotheses of the study will be presented. Due to the private nature of the industry, it was impossible to get quantitative data on a lot of central aspects of management ownership programs. However, in the author's point of view this is no reason to neglect the analysis of these focal issues, especially as the aim of the study is to offer a broad overview of the so far unexplored area of research. Consequently, the analysis is based on two different approaches. Section 3.1 represents the classic academic style and introduces the hypotheses that will be tested using the quantitative data set. Thereafter, section 3.2 presents the primary questions of interest that could not be analyzed using numeric data in form of assumptions. The validity of the assumptions will be checked by interviewing numerous experts and further supporting evidence will be sought by analyzing actual transactions.

3.1 Hypothesis for Quantitative Analysis

Ultimately, the managers will look at how much money they need to be awarded to join the buyout. A small fraction of a large company's equity might be worth a fortune and, consequently, it is hypothesized that smaller shares of equity proceeds are allocated to the management in larger buyouts.

H1: The management's share of exit proceeds declines with company value

Larger companies usually pay higher wages to their chief executives than smaller businesses. As a significant portion of a portfolio company executive's remuneration comes in form of the ownership program, it is hypothesized that executives of larger companies get higher absolute payoffs.

H2: The absolute profits of managers following an exit rise with company value

The management usually makes high profits out of a successful exit, which needs to be taken into account by a private equity investor in a secondary buyout when developing his management ownership program. To expose the management team to real personal risk, the

investment amounts allocated to the participating managers are likely to be larger in secondary buyouts than in primary transactions.

H3: The share of equity granted to the management is higher in secondary buyouts than in primary buyouts and, as a result, they also receive a higher share of the exit proceeds

The managers are poorly diversified as both their income and wealth is bound to the same company. To induce them to risk taking that exceeds their own preferences but which is on an appropriate level for the financial investor they need to be offered a levered upside in case of success.

H4: Base case returns are considerably higher for the management than the sponsor, which are reflected in envy ratios significantly higher than one

3.2 General Questions of Interest

Next, important aspects of management ownership programs that could not be analyzed using the quantitative data set will be presented in form of assumptions. The assumptions are based on earlier literature, explorative interviews with industry experts and views of private equity fund professionals.

From a theoretical point of view, direct equity participation is the best way of aligning the management's and financial investor's incentives. Thus, it is hypothesized that most management participation programs are based on real equity instruments and that the managers stand to lose their money in case that the company fails.

A1: Management participation programs are almost exclusively based on real equity and require risk exposure on part of the management

Based on the literature (Sharp 2003, 119), there is an old rule of thumb that managers should be obligated to invest an amount equal to one times base pay in order to guarantee their

highest commitment. The participation amount should exert adequate downside pressure on the managers to make them do all that they can, especially in difficult times.

A2: There is a minimum participation level measured in annual salaries that is required from the managers in most transactions

The management team is an essential part of any successful private equity transaction. If a management team has already proven its capabilities in developing the company and achieved an exit at increased value, they are likely to have a stronger say while negotiating over the conditions of the next ownership program. Additionally, they are already familiar with the situation and have a better sense of the attractiveness of the program offered by the private equity investor as they have gained experience from their first buyout.

A3: Managers are in a stronger negotiation position in secondary buyouts as they have proven to be a well-performing team and have gained experience from the primary buyout

Private equity firms see great initial effort in developing their basic management incentive scheme structure. As they have become increasingly experienced with this particular structure from applying the same principles in their past portfolio companies, they are inclined to use the same model with new investments in order to maximize the predictability of the outcomes and to minimize the chance of legal disputes.

A4: Private equity firms seek to apply the same type of basic structure in all of their management ownership programs and only minor adjustments are made where necessary

Nevertheless, there seems to be some variation in the structures from one portfolio firm to another and these are hypothesized to be mainly caused by differences in the regional legal and tax requirements. For the managers the tax treatment of their proceeds is extremely important and adjustments to the structure such as to fulfill the conditions of beneficial ownership in order to make capital gains taxation possible are assumed common.

A5: The tax-treatment of instruments and the feasibility of vesting conditions are major factors affecting structuring choices

Top executives are increasingly willing to leave the rather comfortable life and the financial security connected to working at a large public firm to work for a buyout company. The prospect of operating independently of the head office strictures is almost as attractive as the potential financial rewards. An interesting question to look at is how highly the manager candidates value the privacy of their remuneration arrangements which is likely to fend off any negative publicity concerning excessive rewards.

A6: The privacy of the schemes is a significant factor in attracting top level executive talent

A fundamental question is whether it is possible to align the management's interests with the shareholders' when the management does not own a significant equity interest in the company. In public firms share options have been used to solve the dilemma, but do instruments that do not entail any downside risk really work properly? Additional difficulties stem from the need of communicating with a large group of investors with deviating interests.

A7: The incentive schemes are more effective in aligning the management's incentives with the shareholders' in private equity than on the public side

The validity of assumptions 1 through 8 will be tested by interviewing a number of advisors and practitioners that work with management ownership programs on a daily basis. Additional affirmation will be sought by scrutinizing management participation programs from actual transactions.

4 Data and Methods

Several different types of data are used in this study to provide a multifaceted view on management participation programs. To begin with, common terms and procedures related to the contracting of management ownership programs will be explained and a term sheet template is attached in the appendices to provide a practical example of their use. After the reader has received a basic understanding of the concepts, numerical analysis based on uniform transaction data on 29 buyouts and their management participation programs will be conducted. Further insights on aspects not covered by the numerical analysis will be drawn from miscellaneous documents from six European transactions. Additionally, external advisors and fund professional are interviewed to validate the earlier findings and to get further information on the programs. Their overall views will be reflected while analyzing the main components of management ownership programs and discussing different structuring alternatives.

4.1 Management Participation Contracts

4.1.1 Terms and Procedures Connected to MOPs

To provide an encompassing overview of management participation programs, I will first explain the usual terms used in the agreements and describe the procedures behind the different clauses. A term sheet template used as a basis in German private equity transactions is presented in Appendix 1 to show which conditions are normally explicitly agreed over. The sample term sheet was received from a leading German law firm that specializes in legal and tax advice in M&A and private equity transactions.

4.1.1.1 Purchase of the Management Equity

The management participation occurs either through (i) the acquisition of an equity interest in the company by the management alongside the private equity investor or (ii) the subscription of shares within the scope of a capital increase. The purchase or subscription price for the equity interest acquired generally corresponds to the price paid by the investor for the equity capital. Sweet equity – the management buying their share at a discount - is also an alternative, however, usually not recommended due to tax reasons.

Generally, only the most critical executives for the success of the company, referred to as key people, get to participate with significant investments. In many tax regimes immediate economic ownership, i.e. the manager bears the risks and appreciation potential of the investment and is admitted all general stockholder rights, is a requirement for capital gains taxation to take place. The management may also be requested to provide shareholder loans to the NewCo, however, these are normally insignificant in size or not granted at all.

4.1.1.2 Financing of the Management Participation

Generally, the purchase price becomes due and payable immediately upon the transfer of the respective management equity. Since the management is most likely not able to finance their share with private funds, they are usually dependent on external financing. The financing can be provided by banks or even the financial sponsor.

4.1.1.3 Guarantees in the Participation Agreement

The management must typically provide for warranties to the financial investor, such as that the information contained in due diligence reports on the target prepared by the advisors to the buyer is correct and complete. Additional common clauses include the management having no knowledge of any fact which might have a negative impact on the business development and projections in the collaboratively coordinated business plan of the target. Any liability under such guarantees is normally restricted to an amount equal to the equity interest acquired by the management.

4.1.1.4 Drag-Along and Tag-Along Rights

Drag-along rights enable the financial sponsor to force the management to join in a sale process of the company as long as the buyer offers the management equal terms and the offer price corresponds at least to the fair market value. This arrangement is designed to protect the financial sponsor since most buyers – regardless of being an industrial or a financial actor – are only looking to have complete control of a company and want to structure their own incentive schemes if the management is to continue.

The other side of the coin is represented by the tag-along rights that are to protect the minority shareholder rights of the management. Basically, if the private equity firm is to sell its stake, the management has the right to join the transaction and sell their minority stake in the company. Sometimes these are also referred to as co-sale rights.

4.1.1.5 Anti-Dilution Protection

Ordinarily, the management is protected from diluting actions from the financial sponsor's side. In case of a capital increase the managers usually have the right to participate pro-rata to their initial shareholding, yet they are not obliged to do so as their liquidity is typically limited. Thus, the right to subscribe to new shares often doesn't provide sufficient protection and capital increases ought to be undertaken at the fair market value not to violate the management's economic rights.

4.1.1.6 Negative Vesting and Good Leaver / Bad Leaver Clauses

The realization of investments is usually tied to specific time frames. Due to tax reasons, the managers generally receive their equity stake immediately at the beginning of the investment period in total, but their investments are subject to being called in leaver situations. The circumstances and reasons for the premature cancellation of the employment contract determine the price at which the financial sponsor buys back the management equity.

According to a classic interpretation, a bad leaver is a manager who terminates his employment agreement by himself voluntarily (i.e. not for cause) within a short time period following the signing of the management participation agreement, a manager who is in material breach of the management participation or service agreement, or whose employment contract is terminated by a group company for cause.

A manager whose employment contract with the company ends and who is not a bad leaver (e.g. manager asked to leave the company without cause) is a good leaver. The financial sponsor usually has a call option vis-à-vis both good and bad leavers. In addition to this, good leavers who leave the company due to death or permanent disability generally have a put option towards the company. The repurchase price in good leaver cases is usually the higher of the acquisition costs (plus possible interest) and the fair market value. Bad leavers usually have to content themselves with the lower of the two.

Table 6: Example of a Leaver Scheme

Leaver Scheme Call-Options	Valuation
1. Permanent disability 2. Retirement after a minimum of [•] years employment after closing the transaction 3. Death	Higher of acquisition costs and FMV*
4. Termination[1] by the manager with important cause 5. Termination[1] by the company without important cause	FMV
6. Termination[1] by the manager without cause after [•] years following the closing	Lower of acquisition costs and FMV
7. Termination[1] by the company with important cause 8. Termination[1] by the manager without cause within [•] years after closing the transaction	Lower of acquisition costs and asset value
9. Other reasons no stated in 1-8	Lower of acquisition costs and FMV

Leaver Scheme Put-Options	Valuation
1. Permanent disability 2. Retirement after a minimum of [•] years employment after closing the transaction 3. Death	Higher of acquisition costs and FMV
4. Termination[1] by the manager with important cause	FMV

[1] also non-prolongation of the contract with economically identical offer
* FMV = Fair market value

4.1.1.7 Repurchase Price and Determining the Fair Market Value

When determining the repurchase price there is usually a differentiation between (i) vested and unvested participations and (ii) good leaver and bad leaver cases. The effective terms are always separately agreed on between the parties, but Table 6 offers a summary of some classic good leaver / bad leaver interpretations. As a rule of thumb, bad leavers always receive the lower of (i) the acquisition costs and (ii) the fair market value regardless of

vesting. Good leavers normally receive the acquisition costs for the unvested shares and the higher of (i) the acquisition costs and (ii) the fair market value is paid for the vested stake.

The principles of determining the fair market value ought to be as simple as possible and clear to all parties from the beginning. Nevertheless, there are big differences in the ways in which the firms do it in practice. Some take reference to internal value assessment methods from the local venture capital association while others do it using their own formulas. In case of disagreement a renowned advisory firm or investment bank is asked to act as an arbitrator. According to practitioner interviews, the most common formula applied is the following – twelve month averages are often used to avoid sporadic extreme values.

(1) Fair market value = Entry multiple x EBIT(DA) – Net debt

There is also the possibility of retrograde valuation, i.e. in a good leaver case there is no fair market valuation when the manager leaves, however, linear growth in the company value is assumed and the manager receives the difference between acquisition costs and exit proceeds pro-rata to his tenure of the total holding period at the point of exit. Thus, only the acquisition costs are reimbursed to the manager when is to leave, but he receives additional funds if the company value proves to have increased at the exit.

4.1.1.8 Ratchets

Ratchets are synthetic arrangements that either increase or decrease the management's share of exit proceeds. Negative ratchets are used to further strengthen the performance incentives of the managers. By decreasing the management's equity share in case the performance targets of the business plan are not met, the financial investor tries to induce the managers to work hard. With help of positive ratchets the financial investors can further award the management for outstanding performance. According to tentative discussions with advisors, ratchets are usually based on investment performance measures, above all IRR and money multiple targets. Scalar return profiles with distinctive upside intervals may be applied, e.g. additional proceeds for IRR levels between 30-32 percent, 32-35 percent or above 35 percent. If a combination of an IRR and a money multiple target is to be reached, the management has to bear the following tendencies in mind; quick exits often lead to high IRR levels but low

money multiples and late exits to the opposite outcome. Thus, reaching a combination of the two might be challenging with unconventional investment periods.

4.1.1.9 Tax considerations

The designing of drag-along and tag-along rights, negative vesting schemes and ratchets requires special attention to ensure the management's economic ownership and thus favorable taxation. In general, tax-issues are a primary driver affecting the choice of instruments in structuring management participation plans and have a significant impact on many conditions in MEP agreements as well. Going into a deal, the management needs to be protected from a tax charge on acquiring sweet or cheap equity. At the point of exit, the most beneficial tax-rate ought to be applicable, which usually means that the management proceeds should be viewed as capital gains.

4.2 Data Sets for Analysis

In this section, I will describe the two different data sets of the study, one for the quantitative and one for qualitative analysis, and the methods in which they were gathered. Due to confidentiality reasons, I am unable to provide more specific information about the transactions and individual interviewees than what will be disclosed in the text.

4.2.1 Uniform Transaction Data for Numerical Analysis

The comparative numerical analysis is conducted using a unique data set received from a European consulting firm specializing in management incentive schemes. The data set consists of detailed numerical data on 29 buyouts and their respective incentive schemes completed during a period between 2001 and 2004. Just four of the 29 transactions are secondary buyouts and thus only indicative analysis of differences between primary and secondary buyouts can be conducted.

4.2.1.1 Sample Description

For each transaction, the data was collected at the buyout stage and thus no records of actual outcomes or returns are available. However, in a real investment case the managers must make their decisions on same kind of information as used in this study – in a situation where the base case forecasts of the jointly constructed business plan act as the best proxy for future development. Table 7 summarizes the descriptive statistics of the whole sample. Unfortunately, there are some transactions in which it was not possible to receive data on all the variables, which is reflected in N being lower than 29.

Table 7: Descriptive Statistics for the Whole Sample
This table presents the main variables for the whole sample in the data set for quantitative analysis. The columns provide the name, average, median and standard deviation of each variable. The last column shows for how many transactions data on that particular variable could be attained.

Variable	Min	Max	Average	Median	Standard Deviation	N
Multiple Mgmt	3.00	37.22	13.98	10.85	9.31	29
Multiple PE	1.69	9.44	3.94	3.80	1.78	29
Envy Ratio	1.25	14.09	4.05	2.67	3.32	29
Risk Multiple Mgmt	0.00	5.13	0.36	0.14	0.40	28
Risk Ratio	0.00	1.00	0.64	0.86	0.40	28
Transaction Size (EV)	52.0 m€	1700.0 m€	487.8 m€	370.0 m€	455.5 m€	23
Holding Period Years	4.00	5.33	4.93	5.00	0.32	29
Exit Multiple on EBITDA	4.50	10.00	7.00	6.50	1.51	29
Mgmt % of Common Equity at Entry	1.00%	22.00%	8.49%	7.00%	5.49%	27
Equity Value (incl. SH Loans) at Exit	54.4 m€	2327.8 m€	560.9 m€	406.8 m€	537.0 m€	29
Mgmt Equity at Exit	2.9 m€	111.7 m€	36.0 m€	31.3 m€	27.2 m€	29
Mgmt % of Equity Proceeds at Exit	1.32%	20.50%	7.67%	6.59%	4.28%	29

The management and private equity investor money multiples reflect how many times return the co-investing parties expect to get on their initial investment by increasing the value of the business and simultaneously repaying debt. Let's assume that the management subscribed to equity instruments with an amount equal to three million euros at the point of the buyout. As a result of achieving the base case targets of the business plan, they are to receive exit proceeds in value of 42 million euros. This would lead to a money multiple of 14 for the management. Usually the sponsor's equity investment is significantly larger, say 50 million in this case. If they are to receive 200 million in exit proceeds, their four-fold return would correspond to a money multiple of four.

The managers need to be compensated for the higher risk resulting from their poor diversification and, consequently, their base case multiples are normally significantly higher than for the financial investor. Another factor leading to the higher base case management

multiples is the fact that they usually share a disproportionate portion of the downside risk, as was depicted in the illustrative return profile graph in Figure 3, and the higher upside potential is to compensate for this. The management's upside leverage is measured by the envy ratio which shows how many times the management's base case return on their initial investment is higher than for the financial sponsor.

(2) *Envy Ratio = Money Multiple Management / Money Multiple PE*

Table 4 shows that in these 29 transactions the management received, on average, a four-fold return compared to the financial investor. However, their initial investments in absolute euros were naturally on totally different levels and thereby their absolute payoffs as well.

The risk multiple for the management shows what portion of their initial investment the managers recover in case that the investment is unsuccessful and no equity value is created, i.e. when the financial investor reclaims his original equity investment at a money multiple of one (PE multiple = 1). Based on explorative discussions with practitioners, private equity investors always want the management to bear real risk of losing their money. This effect is further enhanced by the fact that in most cases the company value must increase significantly before the management starts making a profit. For instance, in the typical return profile structure illustrated in Figure 3, a one and half time return on equity must be achieved by the private equity investor before the management recovers their initial investment. The management's return multiple when the private equity multiple equals 1 – the risk multiple – is 0.7 in the illustration.

Another aspect stressed by the experts was that by accepting more of the downside risk the managers can further lever up their upside potential – so it's a classic trade-off between risk and return. The risk ratio – calculated by deducting the management's risk multiple from one – measures the management's risk in an intuitive way; i.e. the higher the risk ratio, the more risk the management bears. The risk ratio is by definition non-negative. The data mirrors the expert opinions well as the managers reclaim, on average, just 36 percent of their initial investment when the financial investor has a money multiple of one, which leads to a risk ratio of 0.64.

(3) Risk Ratio = 1 – Risk Multiple Management; when PE Multiple equals 1

The next two variables measure basic transaction parameters, the enterprise value at the buyout and the planned holding period in years. The exit multiple on EBITDA illustrates the level at which the co-investing parties intend to exit the investment at the end of the holding period. The management's share of common equity is not comparable with the last three variables, as these measure total equity and thus include potential management shareholder loans or preferred equity as well. Unfortunately, no data on the initial portions of shareholder loans or preferred equity allocated to the management could be received. Nevertheless, this is a minor shortcoming as these tend to be insignificant in size.

One should observe that the last three variables – total equity value, management equity and management's share of equity proceeds at exit – do not measure actual outcomes but the resulting position in case that the base case depicted in the business plan is realized. The typical business plan rests on quite a positive outlook as the resulting equity value net of debt, on average, exceeds the initial enterprise value of the company. Thus, it can be inferred that the expectations on increasing the value of the company are substantial. The final two variables quantify the management's share of equity at exit in absolute and relative terms.

For further analysis, the data set is split into primary and secondary transactions consisting of 25 and four transactions, respectively. Table 8 and Table 9 show the descriptive statistics for both groups separately.

Table 8: Descriptive Statistics for the 25 Primary Buyouts
This table presents the main variables for the 25 primary buyouts in the data set for quantitative analysis. The columns provide the name, average, median and standard deviation of each variable. The last column shows for how many transactions data on that particular variable could be attained.

Variable	Min	Max	Average	Median	Standard Deviation	N
Multiple Mgmt	3.40	37.22	14.65	10.85	9.74	25
Multiple PE	1.69	9.44	4.04	3.80	1.86	25
Envy Ratio	1.36	14.09	4.22	2.67	3.52	25
Risk Multiple Mgmt	0.00	5.13	0.29	0.08	0.35	24
Risk Ratio	0.00	1.00	0.71	0.92	0.35	24
Transaction Size (EV)	52.0 m€	1700.0 m€	509.9 m€	345.0 m€	482.4 m€	20
Holding Period Years	4.00	5.33	0.00	0.00	0.33	25
Exit Multiple on EBITDA	4.50	10.00	7.12	7.00	1.53	25
Mgmt % of Common Equity at Entry	1.00%	20.00%	7.81%	7.00%	5.05%	23
Equity Value (incl. SH Loans) at Exit	54.4 m€	2327.8 m€	595.6 m€	446.5 m€	569.9 m€	25
Mgmt Equity at Exit	2.9 m€	111.7 m€	35.7 m€	31.0 m€	29.0 m€	25
Mgmt % of Equity Proceeds at Exit	1.32%	20.50%	7.05%	5.71%	4.24%	25

Table 9: Descriptive Statistics for the Four Secondary Buyouts
This table presents the main variables for the four secondary buyouts in the data set for quantitative analysis. The columns provide the name, average, median and standard deviation of each variable. The last column shows for how many transactions data on that particular variable could be attained.

Variable	Min	Max	Average	Median	Standard Deviation	N
Multiple Mgmt	3.00	14.48	9.81	10.88	4.87	4
Multiple PE	2.20	4.39	3.34	3.38	1.20	4
Envy Ratio	1.25	4.68	2.96	2.96	1.43	4
Risk Multiple Mgmt	0.00	1.03	0.76	0.99	0.50	4
Risk Ratio	0.00	1.00	0.25	0.01	0.50	4
Transaction Size (EV)	160.0 m€	490.0 m€	340.0 m€	370.0 m€	217.9 m€	3
Holding Period Years	4.50	5.00	4.75	4.75	0.29	4
Exit Multiple on EBITDA	5.00	8.00	6.25	6.00	1.32	4
Mgmt % of Common Equity at Entry	6.00%	22.00%	12.38%	10.75%	6.80%	4
Equity Value (incl. SH Loans) at Exit	156.8 m€	494.0 m€	343.8 m€	362.2 m€	144.0 m€	4
Mgmt Equity at Exit	19.7 m€	48.2 m€	38.1 m€	42.3 m€	12.6 m€	4
Mgmt % of Equity Proceeds at Exit	8.79%	12.98%	11.54%	12.20%	1.90%	4

4.2.2 Data from Transaction Documentation and Practitioner Interviews

The key terms of a private equity transaction are contained in the following documents which are prepared by the equity provider's lawyers. The investment shareholders' agreement is the principal document describing the arrangements between the management, NewCo and the financial sponsor. It addresses central matters such as the conditions precedent for the equity investment, the subscription for shares in the NewCo and completion mechanics, financial covenants and exit policies among others (Sharp 2003, 119).

The articles of association form the essential document establishing NewCo and deal with standard items and other significant issues, for instance, rights attached to shares as to dividends and voting, issues of new shares and transfer provisions, and ratchet mechanisms, if appropriate. Finally, the service agreements generally follow the same format as expected for senior employees except that they additionally include complementary restrictive covenants to the investment agreement (Sharp 2003, 119). In practice, the investment shareholders' agreement and the articles of association are often combined in a single document which might be called management agreement or management participation agreement.

For this study, management participation agreements from five transactions and a presentation to the management from one transaction could be analyzed. These provided the author with valuable examples of what kind of instruments and structures are used in practice. Additionally, the author learned about what terms are explicitly agreed over and how the

conditions are spelled out. Expert advisors were consulted in order to specify the precise meaning of intricate provisions and to further develop the author's understanding of the programs. Based on the experience from the individual cases and the discussions with the advisors, I composed a uniform questionnaire to get further insights on alternative ways of structuring management ownership programs and to verify the universality of the earlier findings. A copy of the questionnaire can be found in Appendix 2.

In total, I interviewed 15 external advisors that specialize in private equity transactions using the questionnaire on the telephone. All the interviewees held senior positions at their firms, most of them being partners or heads of operations. Eight of the respondents represented major accounting firms, three of them were transaction lawyers and the remaining four worked at consulting firms that specialize in developing incentive schemes. Five of the advisors were based in the UK, seven in Central Europe, two in the Nordics and one in the U.S., yet many of them covered broad geographic areas besides their country of residence. Going through the questionnaire took on average about one and half hours and, due to time constraints, I was able to cover all questions with just eight of the 15 interviewees. Additionally, I made complementary calls whenever new aspects came up in order to discuss them more thoroughly.

To learn about international and firm specific differences in more detail, I was also in contact with numerous fund professionals. Many of them declined their help due to time and confidentiality reasons, but the six who chose to cooperate contributed with valuable hands-on experience. They naturally represented a somewhat different viewpoint than the advisors as they could also tell about their motivation behind the structuring choices. In order to limit the length of the calls and to concentrate on the most essential questions, I used a condensed version of the advisor questionnaire with the practitioners. In general, these interviews were less structured as they could give more detailed answers to some questions than others and I did certainly not rush them if they were willing to elaborate on practical examples. The interviewed investment professionals had experience from U.S., U.K., Central European and Nordic deals between them.

4.2.3 Sample Selection Issues

In general, there are significant limitations to the validity of the analysis stemming from two main sources. As there is no comprehensive data base on management incentive schemes in private equity available, the data was gathered from a limited number of sources that are both geographically and transaction-wise biased. In the numerical analysis only European deals could be included and, therefore, no inferences for other regions should be drawn. Furthermore, due to the small number of secondary deals, no comprehensive comparative analysis between primary and secondary transactions could be conducted. The main part of the analysis is based on a limited number of individual investment cases and interviews with external advisors and industry practitioners. To moderate their subjectivity bias, I tried to spread the interviews to a group of people with experience from various regions and miscellaneous types of deals. All in all, due to the limitations of the data, the primary aim of the study is to point out what kind of alternative structures are employed in management ownership programs rather than establishing causal relationships.

5 Analysis

5.1 Comparable Transactions

5.1.1 Envy Ratios

The envy ratio distribution for the total sample in Figure 5 shows that in a typical case the management looks forward to make a two- to four-fold return with respect to the financial investor. However, there seem to be cases in which the management must be offered an extremely steep upside to be induced to participate. On the other hand, a steep upside generally requires accepting more risk on the downside as well.

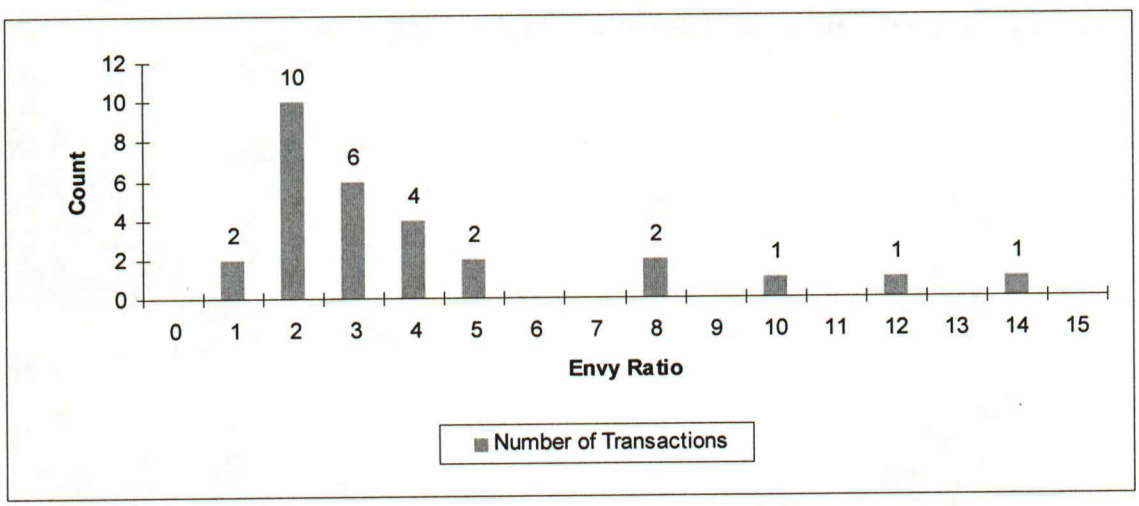

Figure 5: Envy Ratio Distribution for the Total Sample

In secondary transactions, the management has already made a substantial profit from the first buyout. To make sure that the management does not consider the next buyout just a speculative opportunity to gamble for high returns, the financial investor will insist on the management reinvesting a significant portion of the after-tax proceeds made from the first buyout – typically at least 50 percent will be reinvested into the new program. It is even more challenging to find a balance between the fundamental questions of, on one hand, how much equity can the sponsor afford to allow the managers to invest in and, on the other, is that

amount sufficient to align their interests. Generally, managers are also more conservative in their second time around as they do not want to lose the money earned from the first buyout.

Creating an equity strip is a solution often applied in these circumstances. It means that the management invests in exactly the same proportion into all equity instruments with the sponsor and only limited upside is created with a slightly higher share of common equity or with the help of options. Now that the management has also invested a considerable portion of their funds into fixed return instruments such as shareholder loans or preferred equity, their return profile becomes rather similar with the financial investor's. This arrangement serves both parties interests; the managers are able to invest in a more conservative manner and the private equity investor can bind enough of the managers' wealth to the buyout without granting them too much of the upside potential. Figure 6 is in line with the previously discussed attitudes as the envy ratio distribution for secondary buyouts is concentrated on the low end of the total sample. Of course, this is only indicative support as the number of secondary transaction is very limited.

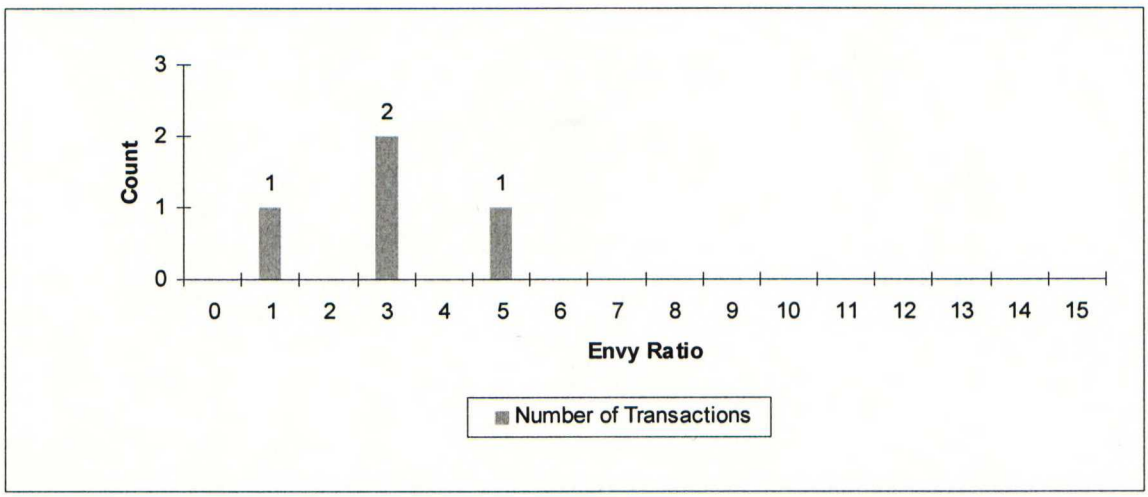

Figure 6: Envy Ratio Distribution for Secondary Buyouts Only

Regardless of whether a primary or secondary transaction, the envy ratios are in all cases higher than one. For the two transactions that make up the lowest column in Figure 5 the envy ratios were rounded down to one. Consequently, Hypothesis 4: "*Base case returns are considerably higher for the management than the sponsor, which are reflected in envy ratios significantly higher than one*" cannot be rejected.

5.1.2 *Risk Ratios*

The risk ratios for the whole sample in Figure 7 loosely resemble an inversed Gaussian distribution. In most of the cases it seems that the financial investor is able to expose the management to elevated risk levels in exchange for high upside potential. Interestingly, second most common in this data set is the other extreme end, i.e. the management bears no notable disproportionate risk in relation to the sponsor. Experts argued that sometimes the management is in such a strong negotiation position that they are able to avoid elevated personal risk. Nowadays, more and more private equity deals are done through formal auction processes in which there are numerous bidders who are highly interested in co-investing with management. The management is likely to use this to their advantage and, consequently, attains more favorable envy ratios and decreases its risk with the investment. The distribution shows that only in a minority of the transactions risk ratios were on in-between levels.

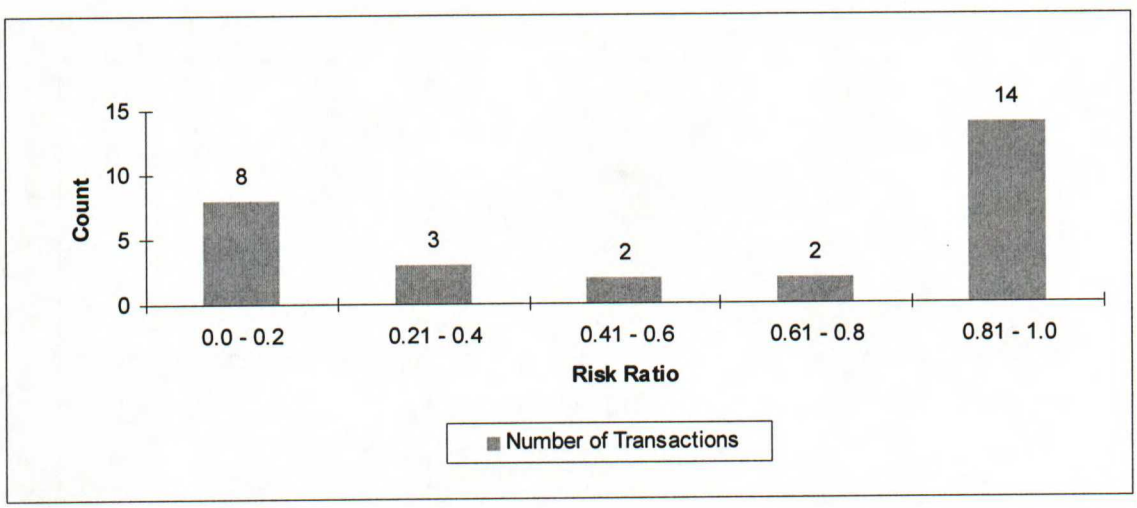

Figure 7: Risk Ratio Distribution for the Whole Sample

In secondary buyouts, the polarization seems to be even stronger, however, the weight is on the low-end as can be seen in Figure 8. In line with Assumption 3, managers seem to be in a stronger negotiation position in secondary buyouts as they have proven to be a well-performing team and have gained experience from the primary buyout. Most likely they are obliged to reinvest a significant portion of their exit proceeds and they are not willing to do it at elevated risk levels. Nevertheless, the risk ratio represents just one point in a return profile and is by no means an exhaustive risk measure.

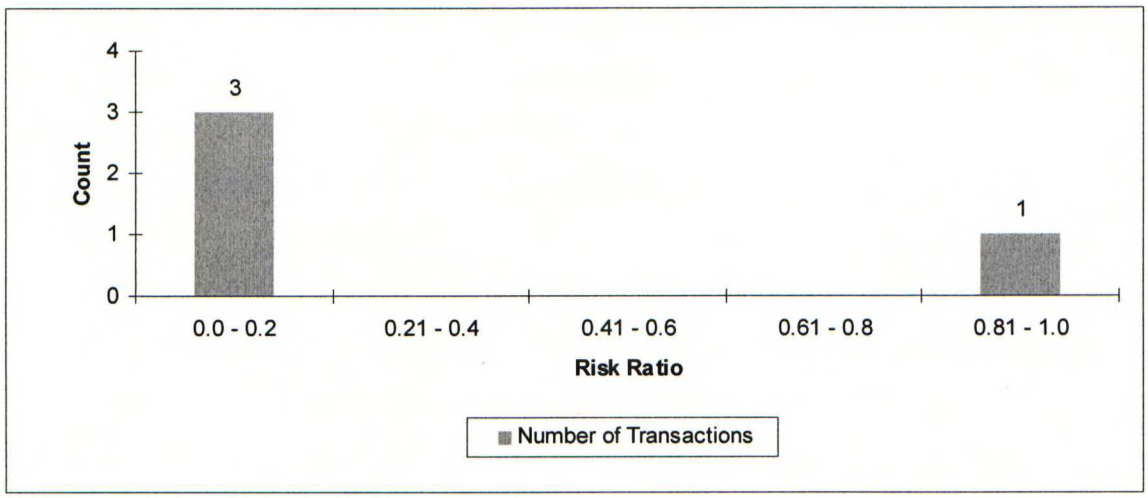

Figure 8: Risk Ratio Distribution for Secondary Buyouts Only

5.1.3 Management's Share of Exit Proceeds

There is large variation in the types of buyouts completed and what kind of negotiation position the management is in. Consequently, there does not appear to be any standard level of the total exit proceeds that is allocated to the management in the base case. After disregarding the transaction with the lowest exit proceeds due to an initial participation irrelevant in size, Figure 9 indicates that the management is normally allocated four to 15 percent of the total equity proceeds from an exit. On average, this corresponds to 36 million euros going to the management team, pointing out that private equity firms are willing to incur considerable costs to secure the management's highest commitment.

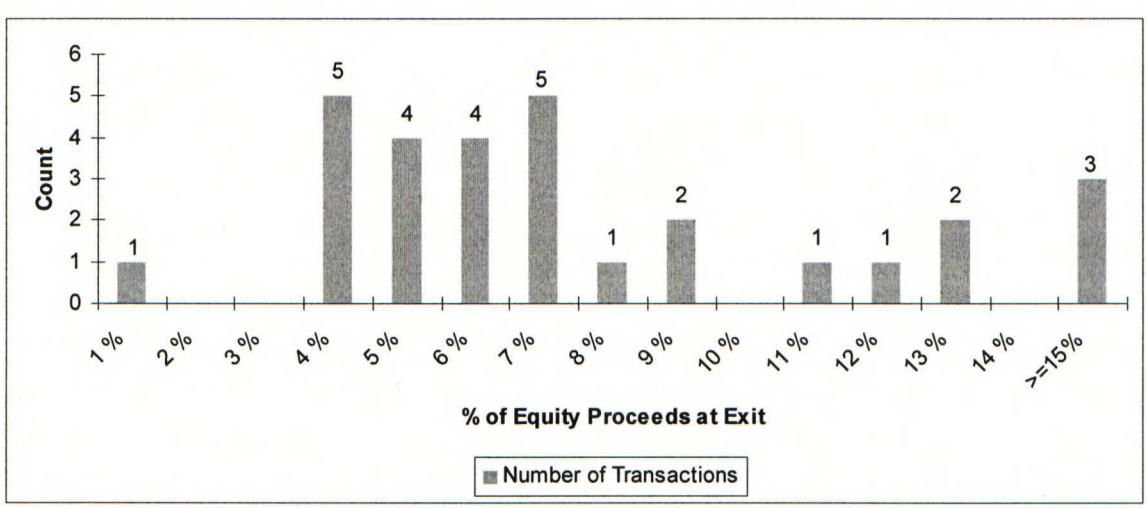

Figure 9: Management's Share of Equity Proceeds for the Whole Sample

Because of the higher initial investments by the managers and more uniform return profiles that stem from investing in a larger set of equity instruments, the proportion of exit proceeds assigned to the management seems to be higher and more consistent in secondary buyouts. Unfortunately, the initial share of total equity subscribed to by the management could not be derived from the data. However, following the successful implementation of the business plan the managers are intended to end up receiving slightly more than 10 percent of the total equity proceeds in secondary buyouts as illustrated in Figure 10. Thus, the data seems to support Hypothesis 3: "*The share of equity granted to the management is higher in secondary buyouts than in primary buyouts and, as a result, they also receive a higher share of the exit proceeds*", since all of the secondary transactions place in the top brackets of the total sample which was illustrated in Figure 9.

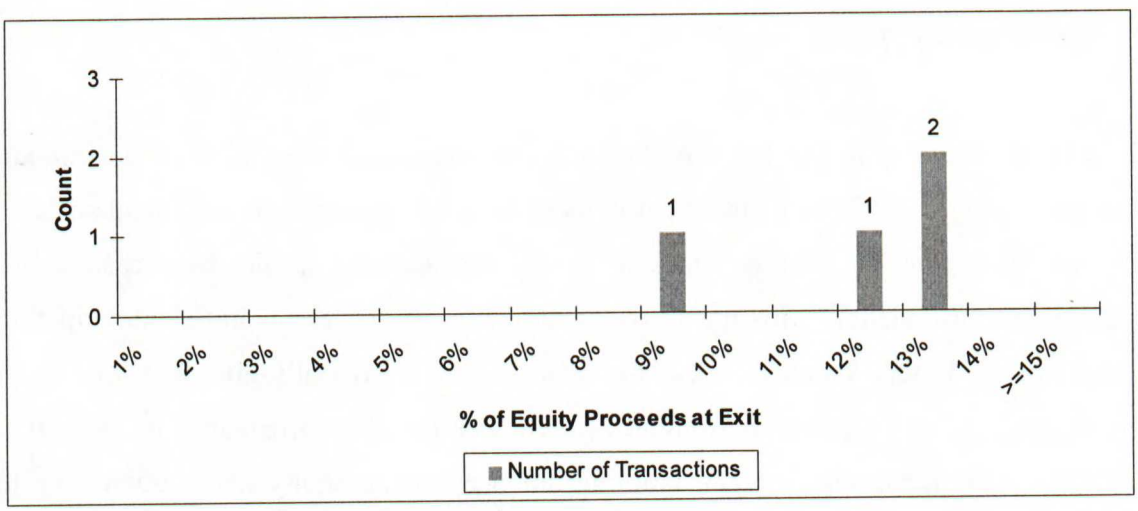

Figure 10: Management's Share of Equity Proceed for Secondary Buyouts Only

To get further support for managers receiving a higher portion of the exit proceeds in secondary buyouts than in primary buyouts, a Welch Two Sample t-test assuming unequal variances was conducted. The average percentage of equity proceeds allocated to the management was 7.05% in primary buyouts vs. 11.54% in secondary buyouts. The test resulted in a t-value of 3.53 which is significant at the 1% confidence level. This indicates that the management's share of equity proceeds is in fact higher in secondary buyouts. The test assumes that the Central Limit Theorem holds, but as there are very few observations the estimated parameters are subject to large error. To address the issue, I bootstrapped the samples since the method does not require the normality assumption to be met and thus can

be effectively utilized with smaller sample sizes. The resulting distributions have very little overlap and are presented in Figure 11.

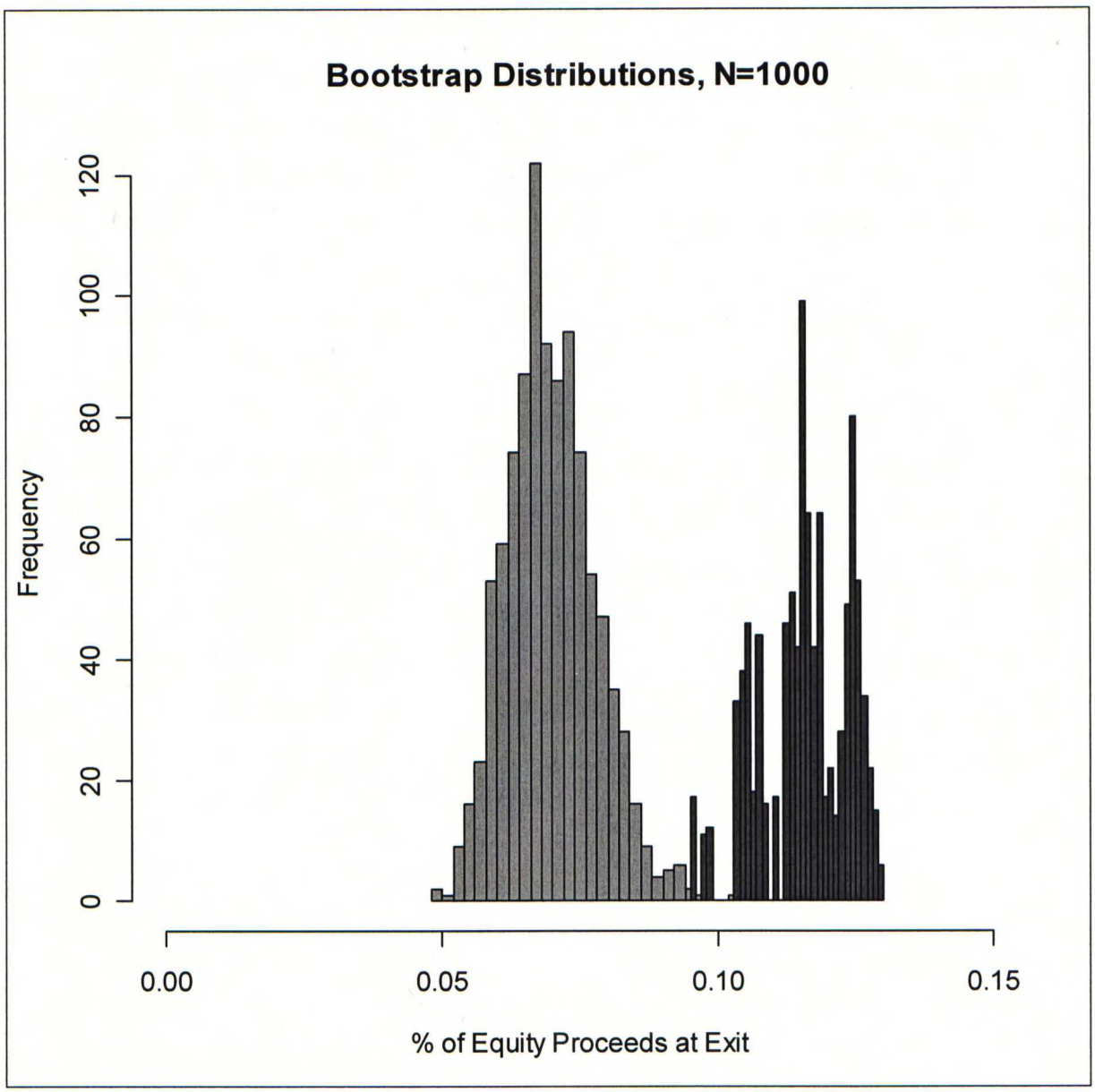

Figure 11: Bootstrap Distributions for the Primary (Left) and Secondary Buyouts (Right)

When 1000 bootstrap samples were used the mean shares of equity proceeds going to the management were 6.99% and 11.59% for the primary and secondary transactions, respectively. The resampling of the data causes the standard errors of the estimated means to decrease and, therefore, the t-statistics become significant at the 0.1% level. To check for the robustness of the results, I additionally performed the non-parametric Wilcoxon rank sum test to compare the means of the two distributions. The hypothesis that the distributions have equal means can be rejected using a p-value of 1%. In fact, I find that the difference between

the means is at least 0.025 using a p-value of 5%. The advantage of non-parametric tests is that they do not assume any specific distribution for the underlying variable.

Unfortunately, data could be received solely on the amount of common equity that was allocated to the management in the beginning and not on other equity instruments that they possible subscribed to. In some transactions, the common equity percentages are lower and upper bound ranges as positive and negative ratchets may affect the final amount of common equity held. No relationship between the fraction of common equity assigned to the management and the size of the transaction could be found, however, this is no surprise as all classes of equity and their specifications are needed to constitute a whole payoff structure.

Next, the relationship between the management's share of total equity proceeds and the equity value realized in an exit under the base case forecasts of the business plan was analyzed. Only a weak negative relationship significant at the 10% confidence level could be found between the management's portion of equity proceeds and the equity value of the company as depicted in Figure 12. Thus, there is some support for Hypothesis 1: *"The management's share of exit proceeds declines with company value"*. However, the equity values are by no means evenly distributed as there are only few cases in which an equity value of 800 million euros is exceeded and clearer results might be achievable with more dispersed data.

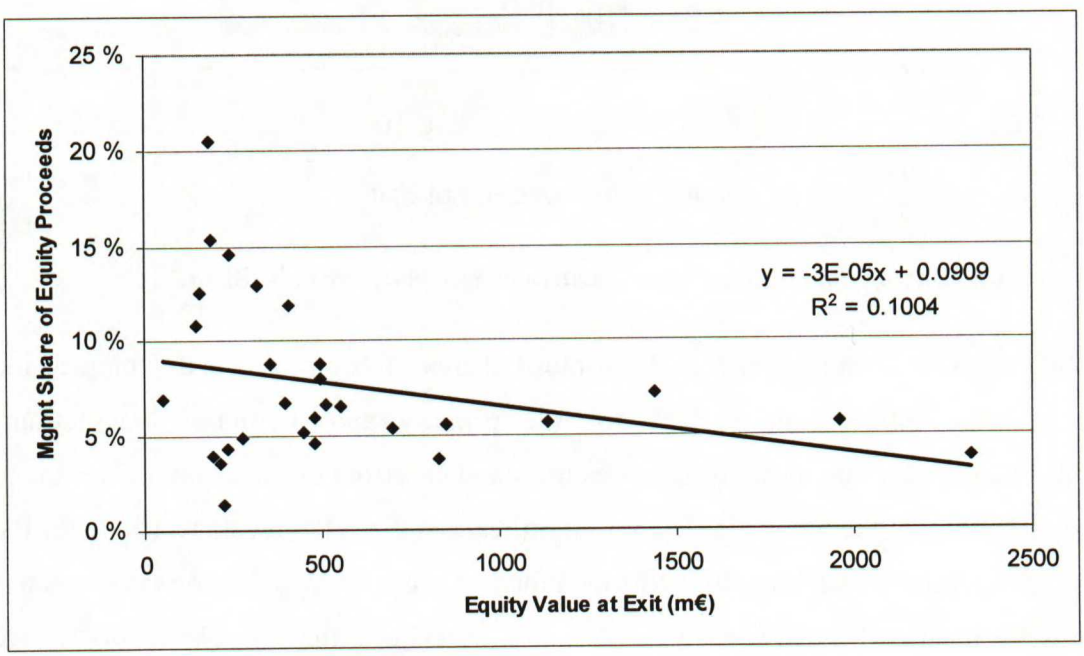

Figure 12: Management's Share of Equity Proceeds vs. Equity Value at Exit

To check for the robustness of the relationship and to address the problem of the unevenly distributed equity values, I also ran a regression of the management's share of equity proceeds against the logarithm of the equity values at exit. In Figure 13 we can see that after taking the logarithms of the equity values, the x-values are significantly more evenly distributed and thus the hefty impact of the few largest transactions is mitigated. The regression line fits somewhat better into the data, which is reflected in a higher R^2-value. Also the p-value turns out lower but does not quite reach 5%.

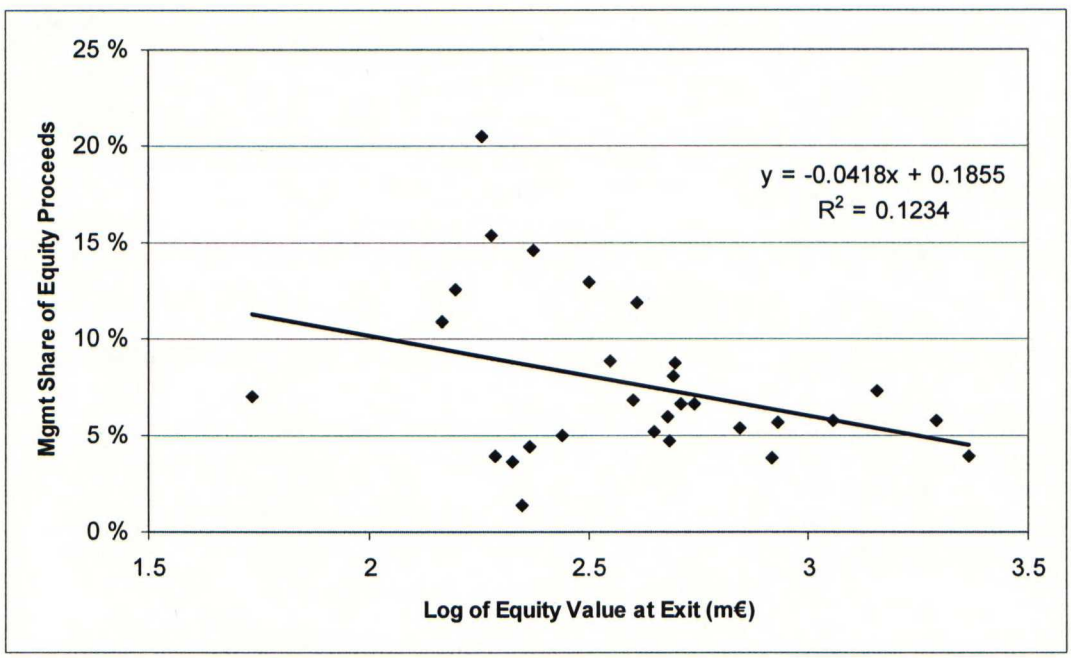

Figure 13: Management's Share of Equity Proceeds vs. Log of Equity Value at Exit

When deciding on the sufficient level of management compensation while structuring management ownership programs private equity houses seem to think in absolute numbers. In general, the larger the corporation the more demanding is the job of the management. At the same time, the success with the largest portfolio companies plays an emphasized role for total fund returns. Consequently, payoffs to the management increase proportionally with company equity value and there is strong support for Hypothesis 2: *"The absolute profits of managers following an exit rise with company value"*, as the regression variable is significant at the 0.1% confidence level. In Figure 14 we can see that the regression line fits well into the set of data points, which is reflected in a high R^2-value.

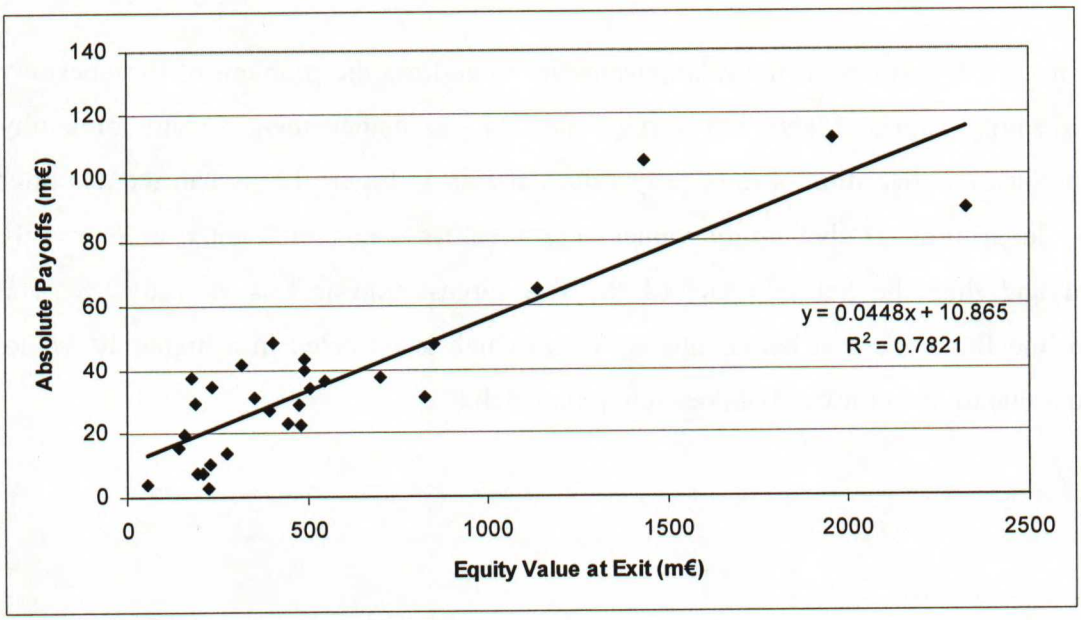

Figure 14: Absolute Payoffs vs. Equity Value at Exit

Again, there is the risk that the few largest transactions give rise to the good fit of the regression and thus I ran the regression also with the logarithms of the values. Figure 15 shows that the fit of the regression is still very good and the relationship is equally significant at the 0.1% confidence level.

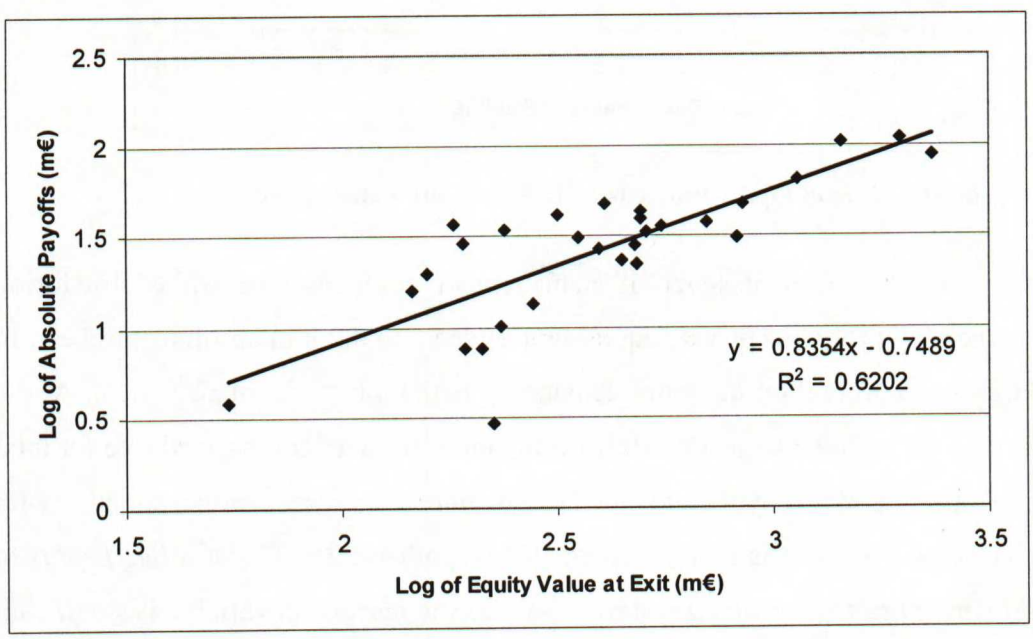

Figure 15: Log of Absolute Payoffs vs. Log of Equity Value at Exit

5.1.4 Summary of Findings

Figure 16 compares the main multiples describing the characteristics of a management ownership program. According to the data, higher equity returns are targeted in primary buyouts as the average management multiple is 33 percent lower and the sponsor multiple 17 percent lower in secondary buyouts. The management is also given a steeper upside in primary transactions – their average envy ratio of 4.2 compares with a mean of 3.0 in secondary buyouts. The deficit on the upside is compensated in the riskiness of the programs, with managers that participate in secondary buyouts having a risk ratio that is 64 percent lower than their counterparts in primary transactions. The numbers suit the experts' views well; managers in secondary buyouts typically take a more risk-averse stance and are willing to give up some of the upside in exchange for safer prospects. Their stronger negotiation position resulting from demonstrated performance and the experience gained from the first process gives them more room in bargaining over the conditions.

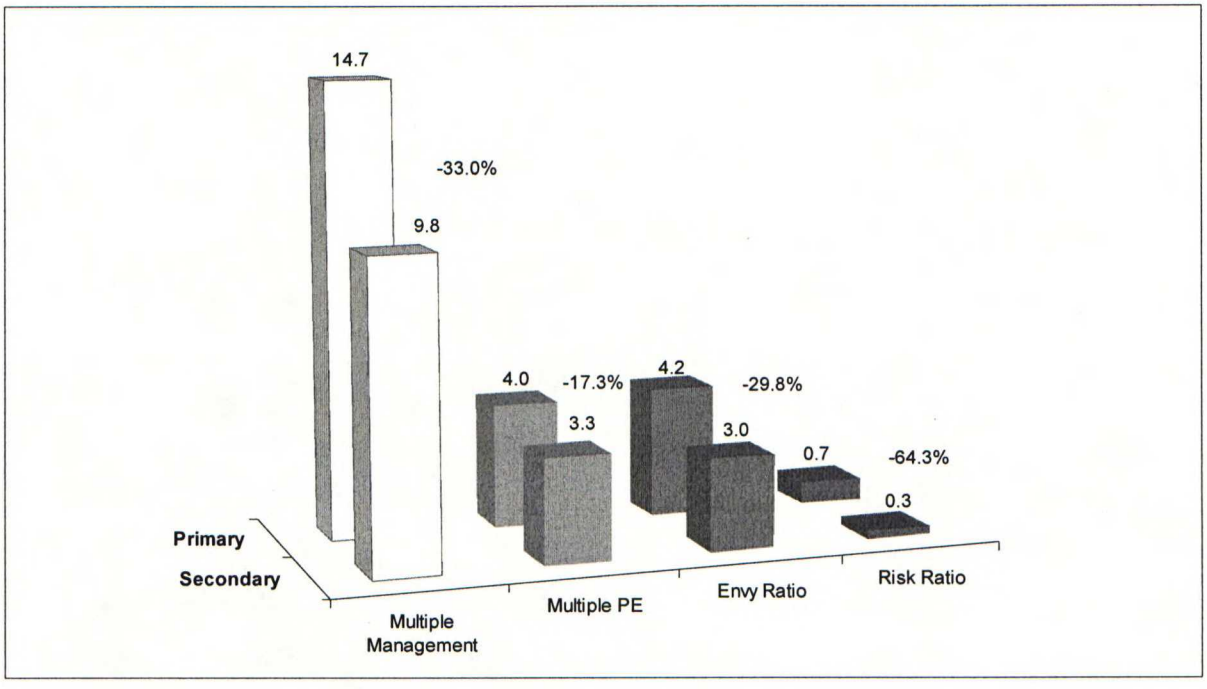

Figure 16: Average Multiples: Primary vs. Secondary Buyouts

A further challenge out of the private equity investor's point of view is the increase in wealth experienced by the management team following a successful exit. To ensure their commitment, the financial sponsors without exception require them to reinvest a significant portion of their proceeds which, in turn, makes it difficult not to grant them too much of the

equity. Due to the higher initial investments in absolute terms, they also end up receiving a higher share of the equity proceeds in an exit. Looking at Figure 17 shows that the percentage of exit proceeds going to the management was, on average, 64 percent higher in secondary transactions than in primary buyouts.

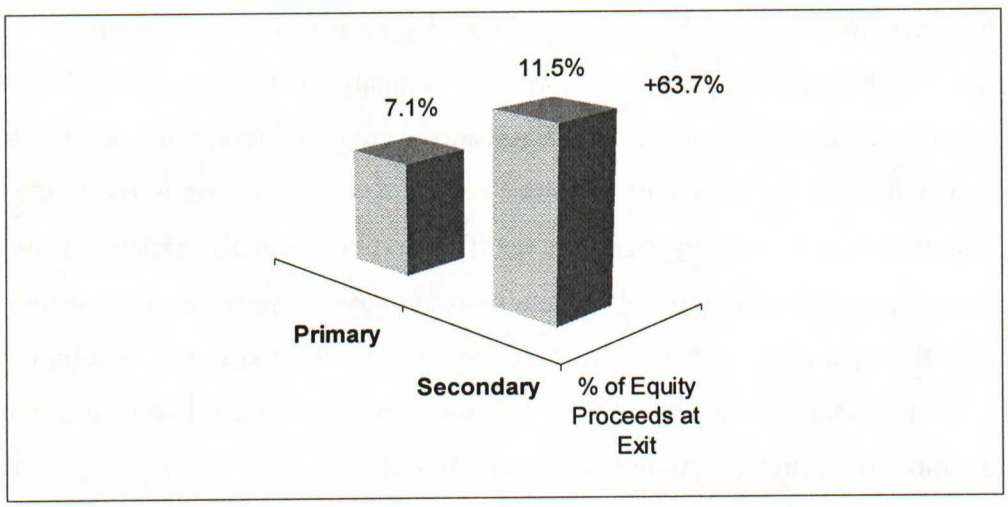

Figure 17: Average Management Share of Exit Proceeds: Primary vs. Secondary Buyouts

5.2 Actual Investment Cases and Practitioner Interviews

5.2.1 Comparing MOPs with Public Company Incentive Schemes

When asked about the biggest differences between management ownership programs in private equity and incentive schemes in public companies, the external advisors had rather similar answers. The interviewees shared the view that incentives are better aligned in private equity portfolio companies as managers typically also bear downside risk due to their significant shareholdings. The very clear upside potential and the straightforward communication with only one or few investors were seen as other major advantages to private equity firms. On the public side, stock price developments might be inconsistent with the management's performance and, due to the tightening regulatory environment, it is difficult for public companies to offer the kind of financial rewards that private equity firms do. Altogether, there was strong support from the advisors for Assumption 7: *"The incentive*

schemes are more effective in aligning the management's incentives with the shareholders' in private equity than on the public side". Yet, public companies offer different kinds of incentives such as job security and a more balanced lifestyle. A lot of people like the kudos of being CEO of a large public company as well.

Due to their exit focus, it is easier for private equity firms to provide information about their absolute goals to the management than for public companies. The funds want to secure good advice to the managers to ensure that the right decisions are made, as they have tremendous financial interest in the company as a result of significant personal investments and their carried interest compensation structure. In addition to their own senior investment professionals on the company board, private equity firms often bring in independent board members with top level industry knowledge. Even though private equity firms try to develop their portfolio companies very quickly, they accept a turnaround taking a couple of years. On the public side, there is little patience beyond one or two quarters as there is a diverse pool of investors with little inside knowledge.

Most of the interviewees considered the non-publicity of the compensation arrangements in private equity a competitive advantage simply as it makes greater payoffs possible. All in all, the higher rewards that can be granted to the managers are a key factor in attracting top level executive talent to private equity portfolio companies as presumed in Assumption 6. Private equity transactions have not caught that much interest in the past, but this is changing as takeovers of major public companies have become increasingly common. Nevertheless, even if there is something in the press it is normally solely based on guesses and no specific information is disclosed. According to the interviewees, sometimes management teams value the simple matter that their equity positions are not made public especially in the Nordic countries. Only in case that the investment is exited by the means of an initial public offering, the ownership program becomes eventually more transparent since it is described in the prospectus.

5.2.2 Number of Participants and Investments Amounts

According to the interviewed advisors, the number of participants is highly dependent on the size of the buyout. In smaller deals usually just the members of the executive team get to

participate in the management ownership program, whereas in larger transactions wider equity participations are more common. Other factors affecting the number of participating tiers are company culture and the line of business; in a financial services firm the program is likely to go deeper down the organization than in a manufacturing company. In secondary buyouts other employees often request to participate, as the awareness of the rewards available is higher and senior managers are also more comfortable with giving away some of the equity. Junior managers often have higher proportional returns but significantly smaller absolute investments so that they don't dilute the key people's returns too much. An example later in this chapter illustrating the use of an equity strip shows what kind of a tier structure and relative investment levels might occur in practice.

To get a picture of how private equity funds determine the number of participating managers in practice, I also talked with several fund professionals about their customs. A shared view was that it is difficult for the private equity investor to know which people are critical for the success of the business. Thus, they often first determine the amount of equity that will be allocated to the management, and then discuss with the CEO who should participate and how the equity should be divided between the managers.

In primary buyouts, the old rule of thumb that one to two annual salaries are necessary to pose enough risk on a manager seemed to hold. The majority of external advisors selected 0.5-1.0 or 1.0-1.5 annual salaries as the most common investment levels, whereas fund professionals said always to require an investment equal to at least one year's salary from the CEO and other key executives. At the same time, they were in unison about the annual salary not being a relevant measure in secondary buyouts, but the amount of money made from the primary buyout being the decisive criterion. There was no clear rule about what portion of the after-tax proceeds ought to be reinvested, but generally the managers are required to invest at least half of their proceeds into the new program.

A practical guideline mentioned over and over again by the practitioners was that managers need to "have enough skin in the game" to make them work at their limits, but not so much that they start losing their sleep. An investment professional stated that one annual salary is their starting point for top executives in all transactions, but that they often, additionally, check up on the wealth of the CEO and CFO to determine their appropriate investment levels. He added that secondary buyout negotiations are usually more difficult and it becomes a

concern if the managers are unwilling to reinvest a considerable portion of their realized funds.

5.2.3 Financing of the Participations

The managers are typically required to finance their participations with private funds. As few managers have sufficient surplus funds at hand, they often need to borrow money from banks. It is not uncommon that the financial sponsor provides the managers with banking contacts and assists with the loan negotiations. The largest private equity funds pay hundreds of millions in underwriting fees and hence they are able to negotiate exceptionally good loan arrangements for the managers. It is very rare that a sponsor secures any of the management's bank loans. However, in exceptional cases there might be an understanding that the private equity investor buys back the management's shares at cost if they are not to blame for the situation.

In some of the direct participation structures that will be introduced at the end of this section, the financial sponsor finances part of the management's shares with non-recourse loans that are only payable in case of an exit. However, these shares only have value if the conditions specified in the vesting schemes are fulfilled and thus are very close to options in nature. In other words, these non-recourse arrangements are rather used to provide the management with more leverage on the upside than to secure their financing. Thus, non-recourse loans by the sponsor might be used instead of options if their tax-treatment is more favorable. A loan from the target company is no alternative in most countries as such arrangements are illegal in numerous jurisdictions.

5.2.4 The Vesting of Management Equity and Leaver Schemes

There are two distinct ways in which the vesting of management equity can be arranged. In some pre-eminently European management ownership programs the vesting occurs solely in shape of the leaver schemes, i.e. if the manager leaves after the buyout all of his shares may be bought back by the sponsor at a price which is dependent on the reason for leaving. In other words, the management shares do not get vested before the exit and these arrangements

are thus often referred to as negative vesting or cliff-vesting. According to some interviewed advisors, U.S. and UK firms tend to be somewhat more sophisticated with their vesting arrangements and often have additional time vesting schedules for the performance portion of the management participation. In some direct participation structures that will be presented later, managers invest to some extent at equal terms with the private equity investor and, in addition to this, get a levered performance portion on top of it. In these structures, the leaver clauses and vesting schedules only apply to the performance portion, i.e. the sponsor has no call rights on the part which is considered the real financial investment.

The vesting of management equity has only relevance in good leaver cases as bad leavers may generally be required to transfer their shares to the company at a price which is the lower of the costs and market value. The private equity investor is typically not obliged to redeem the shares of a manager who is to departure, however, in practice the call option is normally exercised since there is little reason to share future profits with a manager who does not continue working for the company.

Table 10 gives an example of a typical vesting schedule that runs over four years and only applies to a manager who leaves due to a good reason. Depending on the time he has spent with the company, an increasing portion of his shares will be valued at the higher of the initial subscription costs and the fair market value.

Table 10: Example of a Vesting Schedule

Relevant Period	Percentage of Shares Transferred at the Higher of Costs and Market Value	Percentage of Shares Transferred at the Lower of Costs and Market Value
Prior to the first anniversary	0%	100%
On or after the first anniversary but prior to the second anniversary	25%	75%
On or after the second anniversary but prior to the third anniversary	50%	50%
On or after the third anniversary but prior to the fourth anniversary	75%	25%
On or after the fourth anniversary	100%	0%

What is considered a good reason for departure will always be explicitly agreed upon on a deal-by-deal basis, but the following can be considered classic good leaver cases: retirement due to age, death, ill health or permanent disability, employment by a group subsidiary that is sold, and termination of the service agreement by the group without cause. Additionally, the board of the company might have the power to deem any reason a good reason if so desired. Some evident bad reasons are usually spelled out in the agreements as well, but in general anything not separately listed as a good reason is considered a bad reason.

In some deals, the leaver cases are further itemized into good good leavers, good leavers and bad leavers. According to the external advisors, private equity firms have rather similar views on what constitutes a good leaver, however, the valuations for the various events might differ significantly. These inconsistencies also stem from the fact that each management team might try negotiate more favorable conditions for themselves. A legal advisor mentioned that the introduction of a very bad leaver – someone committing fraud and receiving a completely nominal amount for his shares – has been a new phenomenon. Another recent corrective has been the bad leaver classification of someone committing suicide.

The importance of keeping up a fair spirit between the departing parties was emphasized by a fund professional and, consequently, compromises might be sought to limit the harm on the continuing business. Another investment professional mentioned that occasionally more exotic vesting arrangements are used if there are some special value drivers to the investment case. For instance, in a roll-up case the number of acquisitions completed and their valuation levels might be of such importance that it is worthwhile to incorporate them directly into the vesting arrangements.

5.2.5 Ratchets

Ratchets might be used in situations where there is a lot of uncertainty and the range of expected outcomes is large. These synthetic arrangements either increase or decrease the management's share of exit proceeds. Several of the external advisors estimated that ratchets or other synthetic structures are used in about 30% of the management ownership programs, yet their popularity seemed to be decreasing. Many of the fund professionals said that they had been applying them less and less because they make the schemes significantly more

difficult to communicate and easily cause trouble. One professional said that their documentation risk is higher than for any other part of the deal. It may happen that the deal goes well, but the ratchet arrangement has been documented carelessly and, as a result, there is a big quarrel about how to interpret the ratchet payoffs in the end. The ambivalence connected to them seems to be their greatest weakness and a lot of funds prefer to implement the same return profile with real instruments if possible. According to a UK advisor, larger funds have more standard programs and take less use of equity ratchets, since they tend to be complicated and hence employees do not understand them properly.

Ratchets may take many forms and are very flexible in creating the pursued return profile for the management. The different tax legislations set the main constraints on how ratchets need to be structured and thus there are notable differences between countries. Regardless of the location, the vast majority of ratchets are related to actual investment objectives such as IRR or money multiple targets, since these are directly linked to the sponsor's success. According to a UK tax specialist, there are all sorts of ways in which ratchets are structured, but the use of deferred shares is the most common approach in the UK. On the one hand, you can turn some of the institution's shares into worthless deferred shares when the IRR or money multiple conditions are satisfied. On the other, the management might start out with their full entitlement, but some of their shares are turned into deferred shares if the conditions are not met. To avoid questions of interpretation, some tax authorities have published memoranda with examples of accepted approaches such as the Memorandum of Understanding between the British Private Equity and Venture Capital Association and Inland Revenue (BVCA and Inland Revenue 2003). Ratchets may well be structured in differing ways, but following the guidelines can be considered a safe harbor.

In some countries such as Germany positive ratchets that increase the management's shareholding are difficult because of taxation. Ways in which the institution can dilute the management include among other things the conversion of institutional shareholder loans or preferred equity into common equity if the investment performance targets have not been met. A similar kind of ratchet might require the management to exchange some portion of their shares against shareholder loans immediately before or on exit if certain IRR targets are not attained. There is only a fine line between ratchets and vesting, consequently, taking away some portion of the management equity can also be effected through negative vesting arrangements.

Binding a ratchet to the market capitalization realized through an IPO is also a way of setting management incentives. Another straightforward method is simply granting the management additional percentages of performance equity after the achievement of certain threshold levels in the equity value at exit. The management might also receive options if they are e.g. able to double the equity value of the business during the holding period. Operational targets are less common with ratchets but often included in the managers' individual bonus plans.

5.2.6 Return Profiles

It proved very difficult to get any numeric answers on the return profiles of the management and the sponsor as none of the interviewed advisors had studied those more closely. Consequently, the interviewees had to resort to intuitive guesses and only few wanted to express their perception in straight numbers such as typical envy ratio levels. However, the importance of the management's returns relative to the sponsor's should not be overrated, as many of the interviewed fund professionals said that they think in absolute numbers when setting the appropriate level of management payoffs. As a common rule, the management makes lower returns than the sponsor at low money multiples but starts to earn disproportionate proceeds after the hurdle rate on the fixed return equity instruments has been surpassed. So their return profiles are typically leveraged into both directions as depicted in the return profile structure in Figure 3. In contrast to European customs, in American structures that are usually option based the management is often able to avoid downside risk as they do not have to invest any money into the program. Even if they invest it occurs in form of a roll-over into equity at funds terms, which results in equal negative risk with the sponsor. A common view was that generosity varies from fund to fund and with the importance of the management for the success of the deal.

5.2.7 Risk of Losing Money

Whether the management is required to bear considerable risk of losing money in connection with the management equity program emerged as the most notable difference between the U.S. and Europe. In Europe, the way of thinking is that significant investments from the

management are required to guarantee their best possible performance. Especially in the UK it seems to be a cultural thing – the management should be putting up enough money so that they don't go home at five o'clock if thing are not running well, but shouldn't lose their sleep either. As a result, the vast majority of the programs are based on real equity investments and the managers must typically accept elevated downside risk to compensate for their higher upside potential. According to the group of external advisors, in Europe managers always stand the risk of losing money with these investments.

The threshold level before which the management does not fully recover its investment is closely linked to the yield on the fixed return instruments. For instance, if you have a 10% yield on the shareholder loan where the management has no investment, any capital gain is claimed by the sponsor before the IRR surpasses that rate. Consequently, sometimes the institution gets 1.5 times money, but the management doesn't make any return at all. According to an experienced UK specialist, the rates on loan stock were on a 5-6% level five to ten years ago but nowadays normally between 10 and 15 percent. Because of the higher rates on the fixed return instruments management ownership programs ought to be riskier for the management in these days than they were before. The risk ratio can be used as an indicative one point measure of how much extra risk the management is required to carry, however, it is not suited for exceptional situations where the management bears less risk than the sponsor.

In the U.S., managers typically receive at least some portion of their equity for free, either in form of options or performance shares. Even in Europe American firms have a tendency to use structures that contain non-recourse elements or to grant some portion of the shares to the management at a nominal value. Due to the option-like characteristics, the managers don't bear any risk in these types of arrangements. One U.S. fund professional was downright surprised when he was asked about the amount of risk that managers are required to carry. According to him, managers rarely buy their stakes with private funds, however, are generally required to transfer more than half of their existing holdings into the new program in public-to-private or secondary situations.

The main reason that was given for the more favorable position of U.S. managers was the fact that the buyout industry has been going on for much longer in the U.S. Along the years a cult of managers who you want to run your buyout has evolved. These individuals have been so

sought-after that they have been able to avoid almost all personal risk due to their extraordinary negotiation position.

5.2.8 Negotiation Power and Objectives of the Management

The negotiation power of the management varies considerably with the competitive situation of the deal and the team's importance for the company. If the institution is already exclusive in buying the company, little will be bargained about and the management is likely to be able to affect things such as the good leaver and bad leaver terms only to a limited extent. Conversely, if there are numerous interested parties and especially if the management team has started the process they might have significant influence. According to the interviewees, in primary buyouts inexperienced management teams are often impressed by the upside from the beginning. This is particularly common if they used to be a division of a larger company, and thus are unfamiliar with being the center of attraction and executive compensation packages in general.

In secondary deals, the management is generally in a much stronger negotiation position and the financial sponsor might need to make notable economic sacrifices to win over the deal. As the managers make significant financial investment from their primary buyout proceeds, they are very keen on getting most favorable conditions. The team has gained credibility from the first transaction and knows how the process works. Not all is put on the table by the private equity investor on day one, often just the management stake is announced in the beginning. Secondary buyout managers are typically careful about not going exclusive before all important technical details are known to them. Simultaneously, they try to get a better understanding of the new investor and mirror how he compares to the old one. Additionally, the private equity houses are likely to be less tactical since they have seen that the management team has performed in the past. The main points of negotiation concern the economic side, as private equity funds are normally unwilling to bargain over leaver schemes, vesting conditions and the warranties given by the managers beyond a certain range.

A former U.S. fund professional mentioned that public-to-private transactions put the management team in a somewhat challenging position as they are not allowed to discuss the terms of the management ownership program before the deal is announced. Otherwise, they

would be committing a breach of fiduciary duty and become legally incompetent to act in the transaction process. Nevertheless, in reality they are likely to get a picture of what kind of a package is waiting for them in a way or another.

5.2.9 Tag-along, Drag-along and Acceleration Clauses

It appears that the use of tag-along and drag-along clauses has become an industry standard as every single one of the external advisors confirmed them to be always included in management ownership program agreements. Based on the analyzed transaction materials the wordings are quite similar and they generally only come into effect if there is a change in control, i.e. the financial investor ends up with less than 50 percent of the votes. Acceleration clauses are to protect the management's rights in connection with early exits and give rise to the premature vesting of the unvested portions of management equity if an exit is achieved before the expiration of the vesting schedule. According to the group of advisors, acceleration clauses are also common, but not always included in the management participation agreements.

5.3 Instruments and Technical Structures

According to the group of interviewed advisors, direct participations are by far the most common form of structuring a management participation program in Europe; ratchets or other synthetic elements are used in about 30% of these structures. On the other hand, in the U.S. option based programs with no or only minor investments from the management seem to be the norm. In Europe options might be used for the 2nd and 3rd tier to be more flexible with entries and leavers, but almost never used for the senior management except in countries where options are subject to capital gains tax treatment. Phantom stock structures are also rare since they result in cash payments which are typically taxed as employment income. In general, the tax treatment of instruments is a very dominant driver affecting structuring choices, a fact that was confirmed by all of the respondents without exception. Cash bonuses are not uncommon, however, usually they are part of the general remuneration package and not included in the management ownership program. Next, I will present the most common

types of management ownership program structures with the help of illustrative examples. I will start with direct participation structures and conclude the section by describing programs that include key elements which are not based on direct equity investments.

5.3.1 Alternative Direct Participation Structures

In direct participation structures, the management invests in the ordinary share capital of the company alongside the private equity investor. Additionally, they might invest in preferred capital, whether debt or equity, which in a winding-up would rank ahead of the ordinary share capital. Such debt instruments are usually referred to as shareholder loans, loan notes or loan stock, and the interest on them is tax-deductible in numerous countries. In case there are no tax-advantages achievable through the use of debt instruments also preferred equity might be used as a fixed return preferred instrument. The sponsor usually holds all or close to all of the fixed return instruments which make up the bulk of the initial total equity value, whereas the management gets its upside leverage by primarily subscribing to common equity which has typically little value to begin with. The feature that the management starts making disproportionately high returns at some point in a return profile graph is called an equity kicker. An equity kicker can be structured in different ways; some common alternatives will be described next.

5.3.1.1 Common Equity Combined with Disproportionate Shareholder Loans

In Europe, the by far most common way of structuring a management ownership program is allocating disproportionate amounts of common equity and shareholder loans to the management and the sponsor. This structure has been introduced earlier in the study and thus will be just briefly discussed in form of a practical example based on a real transaction. Table 11 breaks down the financing of the transaction and shows how the equity instruments are initially split between the parties. Only about two thirds of the management's funds are allocated the fixed return instrument, whereas the private equity investor puts about 93% of its money into the shareholder loan which makes up the bulk of the initial equity value. This leads to a situation where the management subscribes to 7.7% of the ordinary shares but just to 1.4% of the shareholder loans.

Table 11: Sources of Funds and Initial Equity Structure
The upper part of the table presents the amounts of debt and equity funds raised for the transaction in millions of euros and the percentage of the enterprise value that they represent. In the lower part, the equity structure is further split into ordinary shares and shareholder loans between the management and the sponsor.

Sources of Funds		
Senior Debt	*408.8*	*60.5%*
Mezzanine	*108.8*	*16.1%*
Total Debt	517.5	76.6%
Equity	157.7	23.4%
Enterprise Value	**675.2**	**100.0%**

Equity Structure	**Total**	**Management**	**in %**	**Sponsor**	**in %**
Ordinary Shares	11.8	0.9	7.7%	10.9	92.3%
SH Loans (at 10%)	145.9	2.0	1.4%	143.9	98.6%
Total Equity	**157.7**	**2.9**		**154.8**	

The main goal of the private equity house and the management is to increase the EBITDA and thus the enterprise value of the business. Table 12 shows the projected annual EBITDA levels and the corresponding enterprise values at different exit multiples. The anticipated exit multiple should usually be no higher than the EBITDA multiple paid by the private equity investor at entry. In this example, we assume that an exit multiple of 7.0 is targeted after a four-year holding period and, consequently, the enterprise value at exit would amount to 1023.2 million euros.

Table 12: EBITDA and Enterprise Value Projections
This table shows the expected EBITDA and enterprise value development for the portfolio company in millions of euros. The expected enterprise value can be read by selecting the column corresponding to the planned holding period and the row for the anticipated exit multiple.

Year	**1**	**2**	**3**	**4**	**Exit Multiple**
EBITDA	**101.3**	**120.8**	**132.9**	**146.2**	
Enterprise Value	506.3	604.1	664.5	730.9	**5.0**
	556.9	664.5	731.0	804.0	**5.5**
	607.5	725.0	797.4	877.1	**6.0**
	658.1	785.4	863.9	950.1	**6.5**
	708.8	845.8	930.3	1 023.2	**7.0**
	759.4	906.2	996.8	1 096.3	**7.5**
	810.0	966.6	1 063.2	1 169.4	**8.0**

The total debt has decreased from 517.5 million euros to 449.2 million euros as part of the senior debt has been repaid during the holding period as depicted in Table 13. As a result, an even greater portion of the increase in enterprise value is allocated to the equity holders. The shareholder loan has accumulated at an annually compounded rate of 10% from 145.9 to 213.7 million euros. After the repayment of the shareholder loan 360.4 million euros of equity value is left for common stock holders, which is to the benefit of the management that

holds a disproportionately high share of this asset class. As a result of the beneficial development of the business, the value of their 7.7% stake in ordinary shares has increased from 0.9 to 27.9 million euros. The fact that they achieve a three times higher return on their invested capital (10.5) than the financial sponsor (3.5) is a consequence of their considerably higher relative investment in common equity.

Table 13: Distribution of Exit Proceeds and Return Multiples if Exited in Four Years
The upper part of the table presents the value of the debt and equity instruments in millions of euros and as percentages of the enterprise value in case of an exit after a four-year holding period. In the middle, the equity value is further split into the claims on ordinary shares and shareholder loans by the management and the sponsor. The return multiples for the co-investing parties and the resulting envy ratio are displayed in the bottom.

Exit in 4 years					
Total Debt	449.2	43.9%			
Equity	574.1	56.1%			
Enterprise Value	**1 023.2**				
Equity Structure					
	Total	**Management**	**in %**	**Sponsor**	**in %**
Ordinary Shares	360.4	27.9	7.7%	332.5	92.3%
SH Loans (at 10%)	213.7	2.9	1.4%	210.7	98.6%
Total Equity	**574.1**	**30.8**		**543.3**	
Return Multiples		**10.5**		**3.5**	
Envy Ratio	**3.0**				

5.3.1.2 Common Equity Combined with Other Fixed Return Instruments

In general, the main difference between preferred equity and shareholder loans as a fixed return instrument lies in the possible tax deductibility of the latter. In addition to this, the flexibility of repayment is different in most jurisdictions, i.e. how easy it is to receive money back when it is desired by the equity investors. Shareholder loans are usually more nimble as a commission from the senior lenders is normally adequate for the repayment of the loans. In contrast, preferred equity is considered shareholders' equity and the corporate law in most jurisdictions doesn't allow a company's share capital to be decreased. How complicated the process of repaying preferred equity turns out to be depends on the corporate law in the jurisdiction. Typically, you'd expect to be able to redeem part of the capital, but it is likely to call for a court process and could take several months. According to a fund professional, preferred equity might also be used instead of shareholder loans due to thin capitalization rules. In some countries these rules set a minimum requirement on the amount of equity relative to debt. Shareholder loans as well as preferred equity might be convertible to

common equity and hence both might be used to dilute the management as discussed under ratchets.

The use of special fixed return instruments such as Luxembourg based preferred equity certificates (PECs) and convertible preferred equity certificates (CPECs) is a widespread phenomenon because of the significant tax advantages that they offer. According to premier UK tax specialist, PECs are considered debt for the purposes of Luxembourg but equity for the purposes of the U.S. Using them, it is possible to avoid the Luxembourg capital duty charge and U.S. investors won't need to pay taxes on their accruing coupons before the capital is paid out.

CPECs work somewhat differently, but the basic idea is the same as they are strangely enough considered to be debt in Luxembourg but equity for U.S. tax purposes. They bear a very low coupon, typically between 0.5-1%, and their greatest advantage is that they are convertible into common equity. This feature allows the investors to extract equity profits from the company without redeeming shares in two ways. You can sell the company whereupon the CPECs are issued to the new equity participants on a pro-rata basis and thus they are never converted. If the company is not sold but you still want to extract funds, you can sell back the conversion rights to the company and by this means extract equity profits without having to redeem shares. All in all, these instruments are very common and normally issued by a Luxembourg company which acts as the acquisition vehicle. The nature of the underlying fund investors is decisive for the attractiveness of these instruments. If a private equity fund has numerous U.S. limited partners, PECs and CPECs might offer unparalleled tax breaks.

5.3.1.3 Equity Strips

According to a European partner specializing in private equity, the idea of equity strips originally stems from the U.S. Investing into the strip means that the management invests most of its funds at equal terms and in the same proportions as the financial sponsor does its own investment. On top of that the management gets some free shares or options, however, these instruments are not used in Europe since they are typically taxed at very high rates. To make the same structure work in Europe these are replaced with performance shares which

are only payable upon exit and only have value if certain performance targets are achieved. Often these shares carry initially very limited voting and liquidation rights, but the rights increase when the performance conditions are met. Many American private equity houses still have a slightly different view on how incentives should be aligned than European firms. These U.S. institutions prefer a more direct alignment of interest where the bulk of management's money is invested at equal terms with the sponsor. Altogether, with the equity strip model the return profiles of the management and the private equity house are typically much closer to each other than using the basic approach of combining common equity with disproportionate shareholder loans in a less sophisticated manner.

Equity strips are particularly common in secondary buyouts where the management has realized significant gains from the first buyout, which the financial investor needs to take into account when determining sufficient investment levels for the managers. Typically, most of the existing equity goes into the strip as the sponsor doesn't want to give away too much of the upside potential and additional management leverage is created with the help of options or performance shares. Essentially, the strip is considered the real financial investment and the performance portion is often called sweet equity. Secondary buyouts are by far more common in the UK than in other European countries as they have had the most active primary market in the past.

The example in Table 14 is based on an actual secondary transaction and demonstrates how an equity strip can be structured. Again, the main idea behind the model is that the management invests to some extent at equal terms into the same equity instruments as the financial investor does. In this case the equity strip consists of B Ordinary Shares, A Preference Shares and B Preference Shares. Only the management invests into the A Ordinary Shares which are performance shares that vest gradually over time according to a vesting schedule and might require the fulfillment of certain performance targets. Both the ordinary shares and preference shares have a nominal value of 10 euros. The subscription price for all instruments is 50 euros; the difference of 40 euros for each ordinary and preference share is considered share premium. The A Preference Shares and B Preference Shares entitle the holder to a compounded dividend of 16 and 15 percent, respectively. The preference shares have a preferred right to dividends which shall be rolled up and capitalized each year. No dividends shall be paid on the ordinary shares before the preference shares have received their preferred dividends as set before.

We assume that the management subscribes to four percent of the equity strip and 96 percent is allocated to the financial sponsor. Regardless of the total amount that is invested into the strip by each participant the percentages allocated to B Ordinary Shares, A Preference Shares and B Preference Shares are equal at 5.3%, 35.2% and 59.5%, respectively. These proportions mirror the total equity investment of the institution. The minor variations around the percentages stem from the fact that the shares cannot be divided into smaller units than one.

Table 14: Illustration of a Management Ownership Program Based on an Equity Strip in a Secondary Transaction

MANAGEMENT OWNERSHIP PROGRAM PARTICIPANTS AND THEIR INVESTMENTS

Name	No. of A Ordinary Shares	Consideration for A Ordinary Shares (EUR)	No. of B Ordinary Shares	Consideration for B Ordinary Shares (EUR)	No. of A Preference Shares	Consideration for A Preference Shares (EUR)	No. of B Preference Shares	Consideration for B Preference Shares (EUR)	*Total Consideration (EUR)*	Total Consideration for Ordinary Shares (A+B) (EUR)	Total Consideration for Prerefence Shares (A+B) (EUR)	**Equity Strip** Consideration for B Ordinary Shares and A+B Preference Shares (EUR)
Old Participants												
A	2 500	125 000	2 640	132 000	17 505	875 250	29 585	1 479 250	*2 611 500*	257 000	2 354 500	2 486 500
B	2 500	125 000	1 826	91 313	12 108	605 375	20 461	1 023 063	*1 844 750*	216 313	1 628 438	1 719 750
C	2 500	125 000	1 091	54 563	7 238	361 875	12 231	611 563	*1 153 000*	179 563	973 438	1 028 000
D	750	37 500	239	11 938	1 576	78 813	2 664	133 188	*261 438*	49 438	212 000	223 938
E	750	37 500	229	11 438	1 526	76 313	2 558	127 875	*253 125*	48 938	204 188	215 625
F	750	37 500	140	7 000	925	46 250	1 561	78 063	*168 813*	44 500	124 313	131 313
New Participants												
G	500	25 000	20	1 000	133	6 625	223	11 125	*43 750*	26 000	17 750	18 750
H	750	37 500	70	3 500	459	22 938	774	38 688	*102 625*	41 000	61 625	65 125
I	375	18 750	46	2 313	306	15 313	516	25 813	*62 188*	21 063	41 125	43 438
Director:												
J	5 000	250 000	2 390	119 500	15 850	792 500	26 789	1 339 438	*2 501 438*	369 500	2 131 938	2 251 438

	Percentage of Total Consideration	Percentage of Strip Consideration	Percentage of Strip Consideration	Percentage of Strip Consideration	Percentage of Strip Consideration
Old Participants					
A	4.79 %	5.31 %	35.20 %	59.49 %	100.00 %
B	6.78 %	5.31 %	35.20 %	59.49 %	100.00 %
C	10.84 %	5.31 %	35.20 %	59.49 %	100.00 %
D	14.34 %	5.33 %	35.19 %	59.48 %	100.00 %
E	14.81 %	5.30 %	35.39 %	59.30 %	100.00 %
F	22.21 %	5.33 %	35.22 %	59.45 %	100.00 %
New Participants					
G	57.14 %	5.33 %	35.33 %	59.33 %	100.00 %
H	36.54 %	5.37 %	35.22 %	59.40 %	100.00 %
I	30.15 %	5.32 %	35.25 %	59.42 %	100.00 %
Director:					
J	9.99 %	5.31 %	35.20 %	59.49 %	100.00 %

In addition to the investment into the equity strip, the managers subscribe to varying amounts of A Ordinary Shares. The new participants are managers who didn't participate in the primary buyout. They are assigned significantly lower absolute investment levels, but they get to subscribe to relatively high proportions of A Ordinary Shares which offer them a steeper upside at elevated risk. The participants' cumulative investment into A Ordinary Shares raises their proportion of total common equity to 14% even though they hold less than five percent of the total equity capital. The private equity house's sole investment into common equity occurs in the form of the B Ordinary Shares that are part of the strip. Consequently, each manager has invested a higher portion of his fund into common equity than the sponsor and in case that the hurdle rate of the fixed return instruments is surpassed, i.e. the total equity IRR exceeds the blended rate of the A and B Preference Shares, each manager will receive an elevated share of the excess equity proceeds.

How much the return profile of an individual participant deviates from the financial sponsor's return profile depends on how large the investment into A Ordinary Shares is relative to the investment into the strip by that manager. By definition, the managers invested at equal terms into the strip and thus they have an identical return profile as the sponsor to start with. However, the larger the investment into the performance shares relative to the manager's total equity consideration, the more his return profile will deviate from the sponsor's. Next, we compare the return profiles of participants D and J with the return profile of the financial sponsor to illustrate how the investments into the performance shares influence the managers' returns in different scenarios. In total, participant J invested about 2.5 million euros into the program, whereas manager D's investment represented a mere tenth of it. The deviations in their return profiles stem from the fact that participant D invested a higher fraction of his funds into A Ordinary Shares than participant J.

The first scenario represents the base case of the mutually coordinated business plan which assumes a cumulative aggregate growth in EBITDA of 11.0% over the four-year holding period which is considered the most likely point of exit. The managers deserve to get rewarded for the achievement of the goals set out at the buyout stage and hence they attain higher returns than the sponsor if the base case scenario is realized. Figure 18 shows the money multiples of the two participants and the financial sponsor for exits after various holding periods ranging from one to five years. Participant D achieves a higher multiple in each case because he has invested 14% of his total subscription amount into the performance

shares compared with the 10% of participant J. Yet, participant J invested almost ten times the money that participant D put into the company, reflecting a significant financial investment from the former. Consequently, the private equity firm was most likely reluctant to let him invest any higher of a fraction into the performance shares in order to limit the share of value creation that is allocated to the management as a whole. Likewise, participant J was probably more wary about his considerable financial investment and also from his part wanted to assign a higher portion of it into the less risky institutional strip which is not subject to vesting conditions and the leaver schemes. The lower risk of the strip stems from the fact that a majority of the funds are in preferred fixed return instruments which will be served first in a sale or liquidation.

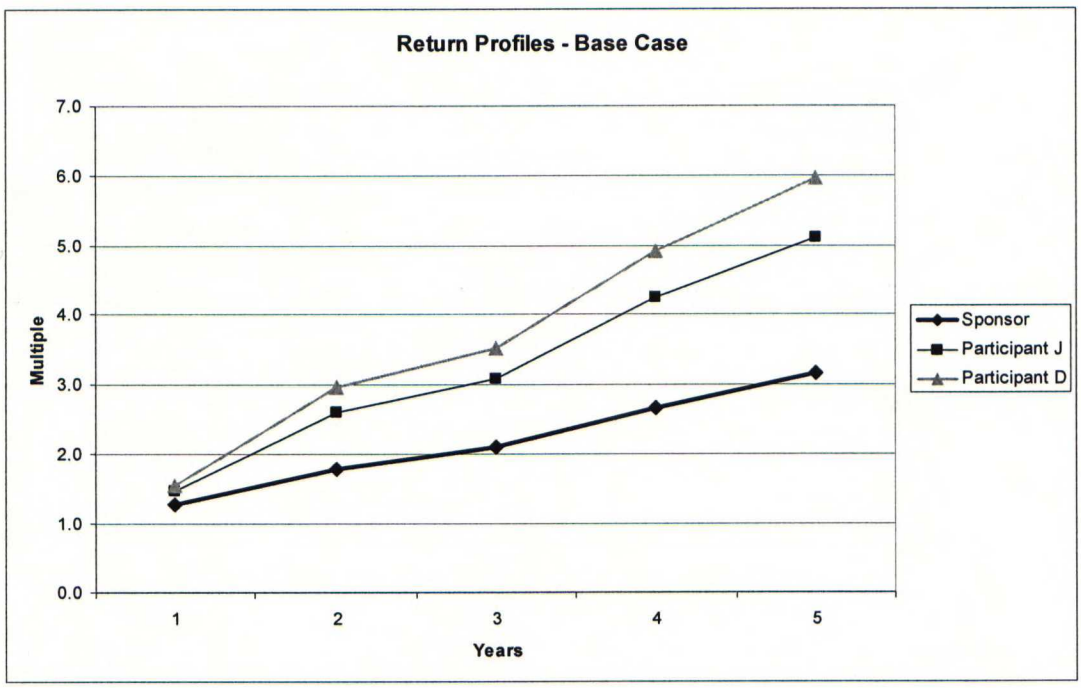

Figure 18: Base Case Return Profile Comparison

In case that the investment turns out a real success and the targeted EBITDA growth is exceeded, the managers receive an even higher share of the exit proceeds, which is reflected in the upside case return profiles in Figure 19. Again, in relative terms participant D benefits even more from the positive outcome as a higher portion of his total investment is in ordinary shares, since all the remaining equity value is allocated to common equity after the claims of the preference shares have been satisfied. The upside case assumes a cumulative aggregate growth in EBITDA of 14.3% over the same four-year holding period, which leads to an about 15% higher EBITDA than in the base case scenario. Following the stronger growth the return

multiples for managers J and D increase from 4.2 and 4.9 to 5.8 and 7.0, respectively. Nevertheless, one has to bear in mind that in the end absolute proceeds count and despite his lower return multiple participant J receives more than 12 million euros compared with about 1.8 million euros going to participant D.

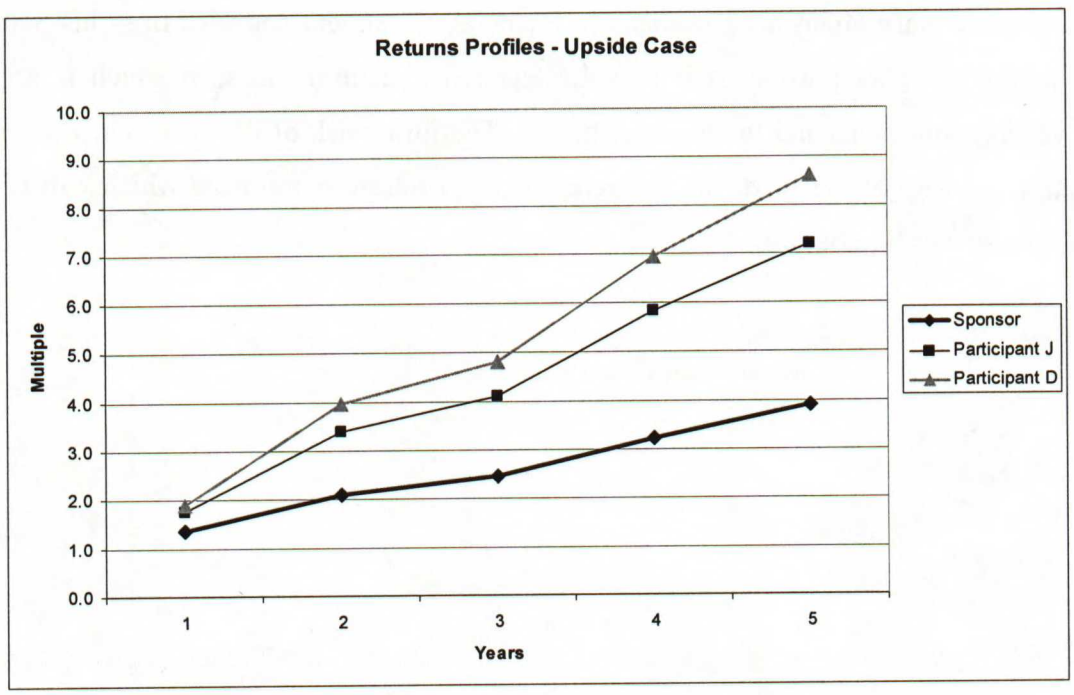

Figure 19: Upside Case Return Profile Comparison

However, there is also the flip side of the coin and several of the interviewees said that a lot of managers lose money in management ownership programs despite the financial investor making a decent return with a portfolio company. The return on the preferred instruments drives this issue since the management's common equity won't be worth anything if the preferred stock or shareholder loans are not fully paid including accumulated interest. The negative side of the management's higher risk taking with the performance shares is illustrated in the downside case in Figure 20. This scenario assumes a cumulative aggregate growth in EBITDA of 7.6%, which results in a 15% reduction compared to the base case EBITDA of the fourth year. Yet again, participant D's return curve is further away from the financial sponsor's profile, however, as the exit proceeds do not suffice for the full repayment of the equity instruments the managers are now losing out on their higher common equity holdings which are subordinate to the preferred instruments.

As the figure illustrates, in downside scenarios the investment into the institutional strip acts as a protective device for the management because that part of their investment will be treated equally with the sponsor's. The higher the fraction a manager's strip investment accounts for, the less he will suffer in form of common equity that cannot be redeemed. As participant D has invested the highest portion into ordinary shares, he is worst off in case that the expectations with the portfolio company are not lived up to. Still, even he has invested close to 86% of his funds into the strip, which ensures that he won't be hurt that much more in case of adversity.

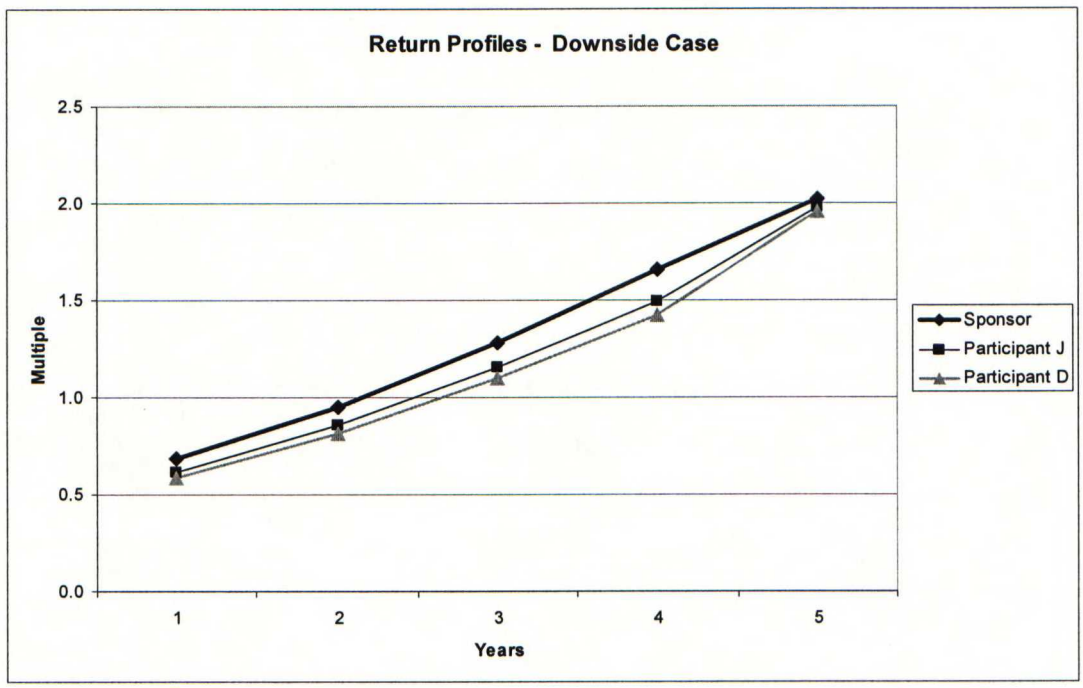

Figure 20: Downside Case Return Profile Comparison

One of the interviewees said that U.S. firms are often more sophisticated with their programs as they are more conscious about vesting and the alignment of interests. With this statement he referred to the common use of equity strips where the part which is considered the real financial investment is put into the institutional strip at equal terms with the sponsor. The strip vests immediately, but the performance portion that comes on top of that – whether in options or performance shares – vests gradually and is typically earned over a four-to-five year period. Using the equity strip approach the return profiles of the parties are a lot closer to each other than when simply investing into disproportionate amounts of common equity and shareholder loans or preferred equity. According to the interviewed experts, the amounts invested into the fixed return instruments by the management are nominal in the typical

European plan, whereas the institutions always have the bulk of their funds in these instruments. Thus, the return profiles of the parties are very different – the management has considerable upside opportunities but simultaneously stands a high risk of losing virtually all of their money. Consequently, a lot of European private equity houses have started using a similar structure in secondary situations where the management rolls over their exit proceeds into the institutional tranche and, in addition to this, a classic common equity – shareholder loan structure is set up.

5.3.1.4 Options on Top of a Pure Common Equity Structure

In some European countries options qualify for capital gains taxation if structured correctly. For instance, in Sweden payoffs from options that are issued by the target and acquired by the management at fair market value will be taxed as capital gains. The option premium needs to be calculated by a modified Black-Scholes formula and the tax authorities must approve that they were sold at a fair price. Nevertheless, typically options are solely used to offer the management some additional upside and significant direct equity investments make up the basis of the program. In other words, even if options are used European firms generally want the management to bear considerable risk to assure their highest commitment. Next, I will show how the same kind of return profile as with a basic common equity – shareholder loan structure can be put together using options on top of common equity.

Typically, a package consisting of a share of common stock and three to four options is structured for the management ownership program participants. The strike price of the options is set at a level so that each bundle is valued at about 15% of a share. We assume that each share costs 100 euros and thus the management pays 115 euros for each package consisting of one share and the bundle of options. The institution invests only in common stock, so no fixed return instruments are employed in this structure. As a result, the return profiles for the management and sponsor turn out similar to the one depicted in Figure 3. Again, the management makes lower returns at low money multiples since they lose the option premium that they paid when they purchased the package in case the options are out-of-the-money. Once their options are in-the-money, they start receiving a disproportionate share of the exit proceeds, which leads to a steeper return curve after the threshold level has been surpassed.

5.3.2 Other Types of MOP Structures

Next, I will present some management ownership program structures that are not based on direct equity investments or at least include major components that do not require the management to put own money at risk. The common denominator for these structures is that they have all been developed by American private equity houses and even today are mainly used by them. At the end of the section also phantom stock structures will be briefly discussed.

5.3.2.1 Separate Option Tranches

According to the interviewees, pure option programs are close to non-existent in Europe, for which two main reasons were mentioned on numerous occasions. First of all, options are not tax-efficient in most European countries. Secondly, especially in the UK many respondents emphasized the importance of the management having their skin in the game. Even in case that the management receives some portion of their equity investment basically for free in form of performance shares bought at nominal value, in Europe they are always required to put some of their own money at risk as well. The concept of the management bearing downside risk was often referred to as pain money.

Due to their stronger negotiation position stemming from the more developed and competitive private equity market, US managers are often able to limit their personal risk and participate at least partially through an option program. An investment professional with experience from one of the major funds said that in the U.S. management options are granted for free and it is uncommon that managers participate with their own capital. However, a roll-over of proceeds especially in large public-to-private and secondary transactions is the norm, with at least half of the money that is realized from the management's current option programs being transferred into the new ownership program. On top of their equity investment, the managers get options whose strike price is usually set at the purchase price of common equity to provide them with a levered upside. With options no fixed return instruments are required to provide the management with upside potential and in a basic U.S. case the sponsor's whole equity investment is allocated to common equity. Preferred equity

might be used in special circumstances, e.g. if a leveraged recapitalization is anticipated prior to an IPO, but not because of the management ownership program.

Here is an example of how the structure can be implemented in practice. For instance, a major U.S. house divides the options into three tranches with a similar number of options in each. Typically, the options in all three tranches have a strike price equal to the value of common equity at the buyout. The difference between the tranches lies in vesting; with the first tranche being subject to time vesting, the second to the achievement of operational targets, and the third to the fulfillment of investment performance targets. The first class of options usually vests in equal proportions over a three to five year period, e.g. 20% at the end of each year over five years. The only condition is that the manager needs to stay with the company.

The performance targets of the second class are based on the base case financial scenario of the management's operating plan. In other words, the second tranche will vest if certain EBITDA or sales target levels are attained. The ultimate structure of second trance is highly dependent on the industry of the portfolio company and is fitted on a firm-by-firm basis to support its operational development in detail. The financial sponsor aims to pay back as much debt as possible while increasing the EBITDA of the business. EBITDA growth might be achieved by dubious capital expenditures with low returns or increases in net working capital. Consequently, the vesting of the second tranche is often conditional on meeting a certain cash flow level in addition to the EBITDA target.

The second tranche might be further split into a long-term and short-term component. The targets for the long-term component are set at the buyout stage for each year separately, but there might also be short-term targets that are revised annually by the compensation committee. So-called look-back mechanisms are quite common with the long-term targets. If the EBITDA target of the first year was missed, but the management is able to reach the second year target, a look-back mechanism will cause the unvested options of the first year to vest retroactively when the second year portion gets vested. In other words, all the unvested options up to that point of the vesting schedule get vested if a later year target level is achieved. According to an U.S. professional, leverage-to-EBITDA levels have increased significantly in the past years and it is often utmost important that the operational performance of the business plan is met in the first years in order to be able to pay down debt.

Thus, sometimes additional cash bonuses are paid to the management for reaching the first years' EBITDA targets.

The composition of the investment performance related third tranche is conventionally pretty straightforward. As the measures of internal rate of return and multiple of invested capital are only realized through a successful exit, this tranche is without exception subject to cliff-vesting, i.e. the whole option stake of the third tranche vests at exit. IRR hurdle rates are normally accompanied by minimum money multiple requirements because quick exits easily lead to a high IRR without any significant financial gain for the sponsor. In general, the target levels of the second and third tranche are organic growth driven. In case of acquisitions, these are adjusted according to specified calculation metrics to reflect the inclusion of the new units. If tax advantages can be achieved, interest free non-recourse loans that are only payable at exit might be used instead of options in the U.S. as well.

5.3.2.2 Separate Share Class Structures

Because of economic reasons, the use of options is not recommendable in the majority of European countries. Consequently, some U.S. houses have developed structures with different classes of equity as a substitute for their traditional option-based programs to be applied on a Pan-European basis. The common denominator in these structures is that the management gets the lowest ranking class basically for free. There are at least two different variants of this structure, but in both the management pays for their ordinary shares and might additionally subscribe to fixed return equity instruments such as shareholder loans. A legal advisor specializing in German private equity transactions estimated these structures to be applied in 30-40% of his deals, pre-eminently in significant transactions by U.S. houses. However, this is likely to be an upside-biased estimate for the market as a whole as private equity firms tend to stick with well-tried advisors and he might simply be doing more deals with certain American clients. Next, I will illustrate two different ways in which the leverage from the subordinated management shares can be implemented.

Subordinated Shares at Nominal Value to the Management

There are two classes of common equity: ordinary A shares and subordinated B shares that are referred to as sweet equity. The private equity investor invests only into A shares, whereas the managers subscribe to a certain number of A shares and B shares, of which the latter cost just a nominal amount, e.g. one penny each. The management's investment into the ordinary shares occurs at the same terms with the financial sponsor, but their B shares which rank below the ordinary shares are subject to good and bad leaver conditions, and only get paid if the claims of all other equity instrument have been satisfied (including accumulated interest). After the A shares have been repaid, depending on the number of B shares relative to the total number of shares, the management starts getting a certain percentage of the value increase on their virtually free B shares. Simply said, the B shares only have value if the private equity fund makes money and thus are very similar to management options in nature.

The main negotiation is on how many A and B shares the management gets in the beginning, since it is known how much trickles down to the subordinated share class in different scenarios. For instance, A shares could make up 20% and B shares 80% of the management's common equity if they simultaneously had significant shareholder loan investments. Sometimes the management does not subscribe to any shareholder loans, then they most likely need to pay for the majority of their shares. A non-recourse interest free loan might also be granted to the management by the sponsor if the managers cannot afford to buy enough shares. Also when using separate share class structures the TopCo's typically sit in Luxembourg or various off-shore locations, yet tax problems for the individual participants might appear. One U.S. fund professional mentioned that they use this structure on a Pan-European basis, but added that it is significantly easier to implement the structure in the U.K. than, for instance, in Germany.

Sponsor Funded Shares to the Management

The starting point is similar as there are A ordinary shares in which the financial sponsor and the management invest at equal terms. In addition to the management's investment into A shares to which they subscribe with their own funds, the management gets B and C shares which are financed by the sponsor through a non-recourse loan that is only payable in case

the exit proceeds suffice. All the shares are essentially of the same class, however, the sponsor funded shares are subject to leaver schemes and separate vesting schedules. Typically, B shares are subject to gradual time vesting over 3-5 years, i.e. a portion of the B shares vests after each year and the manager needs to stay with the company to earn them. C shares are usually conditional on the achievement of IRR or money multiple targets. All in all, the structure is closely related to previously introduced variant, as the sponsor funded shares with their option-like characteristics provide the leverage to the management. If the portfolio company is not a success some of the sponsor funded shares will turn out worthless, however, the management won't be required to repay the non-recourse loan on them. On the other hand, in case that there is enough residual value to be distributed to common equity at the exit, the management will repay their loan to the sponsor and receive any surplus that is allocated to the funded shares. Table 15 offers an example of how the management's total equity investment might be distributed between the different share classes.

Table 15: Example of the Management's Equity Allocation

% of Total Investment	Share Class	Funding	Vesting
30%	A	Private funds	Vest immediately
35%	B	Non-recourse loan from the sponsor	Gradual time vesting over a 5-year period, i.e. 20% of the class vest after each year
35%	C	Non-recourse loan from the sponsor	Performance vesting at exit if an IRR of 25% is achieved

Using this structure it is debatable whether the managers are the beneficial owners of the B and C shares as the non-recourse arrangement clearly limits their downside risk. For instance, in Germany tax authorities are getting increasingly wary of these structures and to verify their feasibility for capital gains taxation these have been brought to the authorities for a binding ruling on the private equity investors' own initiative. According to local advisors, so far even those state authorities who raised the issue could be convinced that the conditions of beneficial ownership were fulfilled due to the financial sponsor's call rights on the funded shares that stem from the vesting arrangements. Nevertheless, many advisors considered these structures potentially risky in the future due to the non-recourse elements.

One German advisor mentioned that the B and C shares could also be financed by the target company, however, then it could not be done by loans but needed to be carried out in form of a capital increase where the management's A shares become payable immediately, whereas

the B and C shares are not due until the exit. If financed by the target it might lead to an insolvency receiver problem and thus sponsor financing is recommendable.

5.3.2.3 Phantom Stock Structures

Due to their disadvantageous tax treatment, phantom stock structures are according to the interviewees only rarely employed. Some had just heard about them from colleagues while others had worked with them on some occasions. Situations where they might be implemented include ambitious turn-around cases where write offs are frequent and hence it would be inappropriate to oblige the management to put money at risk. Phantom structures might also be a solution to situations where the participants are geographically scattered in diverse jurisdictions and direct equity programs could thus be difficult to implement. Due to technical reasons, the financial sponsor might sometimes be required to own 100% of the equity, in these cases one might resort to phantom stock schemes. All in all, phantom stock structures appeared to be significantly more unusual in private equity than on the public side.

6 Discussion and Conclusions

In this thesis, I investigated the structuring of management ownership programs in private equity portfolio companies. Most private equity firms try to apply the same structure in all of their transactions. Depending on the country of the target, different instruments might need to be used, but the basic idea and the incentives for the management remain very similar. The tax treatment of instruments and the feasibility of vesting conditions are primary drivers affecting structuring choices. The most notable difference between private equity funds was found in whether they require the management to bear considerable risk in connection with the management ownership program or not. Each fund's stance on this question has a direct impact on what kind of structures they implement in practice. European funds traditionally view direct equity investments as the best way of setting management incentives; if the managers are willing to bear significant risk they must truly believe in the collaboratively coordinated business plan. American houses often let the management have its upside for free by granting options or non-recourse loans to the managers to finance their equity investments. Indeed, the standard way of structuring management participation programs is based on free options in the U.S.

Table 16 summarizes the main aspects of the different technical structures that came up during the practitioner interviews or were found to be applied in actual investment cases. Apart from the option-based programs, the financial sponsor typically invests only a small portion of its capital in common equity, while the bulk of its funds are allocated to shareholder loans or preferred equity. At the same time, the management usually subscribes primarily to common equity and has a relatively low holding in the preferred instruments. As a result, the management will suffer economically unless the hurdle rate on the fixed return instruments is surpassed, after which value will be allocated to common equity. In other words, the management's higher upside potential is justified by them carrying a disproportionate amount of downside risk as well.

In situations where the management is capable of making significant financial investments, which is usually the case in secondary buyouts, it is in both parties' interests to moderate the management's leverage and bring the return profiles closer to each other. Without notable fixed return instrument investments, the management would end up buying a huge fraction of

the ordinary shares, and in case of success absorb an excessive share of the value creation from the sponsor's point of view. Neither is the management normally willing to accept such a high stake gamble and in these situations often requests to get to invest the majority of its funds at the same terms with the financial sponsor, i.e. to invest into the institutional strip. In practice, the distinction between the different technical structures is not clear-cut and some elements of one structure might well be used in connection with another. For instance, the idea of investing into the institutional strip is regularly used to tie a large portion of the managers' existing wealth to the success of the company, regardless of how the additional upside is created.

With options, no shareholder loan or preferred equity investments are required from the sponsor in order to construct an elevated upside for the management. Consequently, in connection with option programs the private equity fund typically invests solely in common equity. Preferred instruments are used in case they are more beneficial for the deal structure as such, but not because of management ownership program reasons. In Europe, the management normally invests most of its money in ordinary shares and, additionally, buys options at market value. In the U.S., managers typically get their options for free and only subscribe to ordinary shares in case of a roll-over from the previous incentive scheme. As a result, the return profiles turn out very different. Even with a roll-over U.S. managers bear equal risk with the sponsor just on part of the real equity, while the options offer solely upside potential at no risk. Meanwhile, European managers stand to lose their option premium if the exercise price is not reached and thus make poorer returns than the sponsor below the threshold level.

The different view of U.S. private equity houses on whether the management is required to carry elevated downside risk in connection with the programs is also evident with European targets. As options are typically tax inefficient, U.S. funds have developed structures with similar kinds of characteristics based on subordinated or sponsor funded shares. Probably due to the local customs and less competitive environment, also U.S. firms demand direct equity investments from the management in Europe, however, the additional upside is usually provided at no cost in these structures. For European private equity firms it seems utmost important that the management is the first to suffer economically in case the invested funds cannot be reclaimed. This fact was also reflected in the numeric data while the risk ratios were above zero in the vast majority of the transactions.

Table 16: Overview of the Different Technical Structures

This table presents a comparative summary of the different technical structures (H=High, M=Medium, L=Low). The relative comparisons of the management's investment requirement and downside risk exposure in the third and fifth column are based on a typical primary buyout scenario. The management's downside risk can be reduced through lower initial investments, allocating a larger portion in preferred fixed return instruments or lower interest rates on these, immediate vesting and not being subject to leaver schemes. The capital gains intensity rating in the last column indicates to what extent and how widely the structure qualifies for capital gains taxation in Europe.

Technical Structure	Management's Equity Allocation & Typical Investment Requirement	(H/M/L)	Return Profile Characteristics & Typical Downside Risk Exposure	(H/M/L)	Utilization & Capital Gains Intensity in Europe	(H/M/L)
Common Equity with Disproportionate Shareholder Loans or Preferred Equity	Invests exclusively or mainly in common equity that is usually conditional on vesting and leaver schemes Nominal fixed return instrument investments except in secondary buyout situations	H	The hurdle rate on the fixed return instrument drives the management returns Especially with high interest rates considerable risk that the management loses money despite the sponsor making a return	H	By far the most common management ownership program structure in Europe Equally usual in primary and secondary situations, special fixed return instruments such as PECs and CPECs might be used for tax purposes	H
Equity / Institutional Strip Model	Invests mainly into the institutional strip, i.e. in the same proportions and at equal terms with the financial sponsor Additional leverage is created with free shares, options or performance shares	H	Return profiles are closer aligned as both have equal investments to start with --> reducing risk In constrast to the performance portion, the strip vests immediately and is not subject to leaver schemes	M	Particularly common in secondary situations because of the management's significant financial investments Most popular among U.S. funds, but widely used by other firms as well The use of an institutional strip is often combined with other structures	H
Bought Options on Top of a Pure Common Equity Structure*	Invests in packages consisting of one share and a bundle of options The strike price of the options is set at a level which values each bundle at about 15% of a share	H	Similar return profiles as with the basic shareholder loan structure Below the exercise price the management loses the option premium, thereafter higher returns due to the options	H	Applied by European funds in countries where bought options qualify for capital gains taxation The options must be bought at fair market value to be tax efficient	M
Separate Option Tranches*	Management incentives are created by granting free options with different vesting conditions Additional roll-over of proceeds at institutional terms in case of public-to-private or secondary transactions	L	If a plain option structure, the management bears no downside risk With a roll-over into equity, equal return profiles up until the options' exercise price, thereafter a steeper upside for the management	L	Pure option structures are mainly applied in the U.S., in Europe the management is virtually always required to bear downside risk in some form Possibility to incorporate deal specific aspects into the program with the help of the different tranches	L
Subordinated Shares at Nominal Value to the Management	Invests in ordinary shares and gets subordinated shares basically for free; typically also minor SH loan investments The extent to which they subscribe to fixed return instruments is reflected in the proportion of subordinated shares to ordinary shares	M	Classic return profile as a basis, however, the management doesn't bear any risk on part of the subordinated shares The subordinated shares only have value if the sponsor makes a profit (similar to options)	M	Used by U.S. houses as a substitute for their classic option structures on a Pan-European basis Due to the free shares, tax problems might appear; ease of implementation varies between countries	M
Sponsor Funded Shares to the Management	Invests private funds in ordinary shares at equal terms with the sponsor Subscribes to performance shares that are subject to time and performance vesting conditions with a non-recourse loan from the sponsor	M	The management's downside risk is rather limited as they usually pay for a minority of their shares with own funds The upside leverage comes from the option-like nature of the sponsor funded shares	L	Employed by some U.S. funds at least in Germany; in most countries non-recourse loans are rare The non-recourse elements make beneficial ownership questionable, hence binding rulings from tax authorities are typically requested	M
Phantom Stock	No real equity investments are made, but the management receives part of the exit proceeds as if they had participated Result in cash payments which are usually tax inefficient	L	Totally synthetic and thus all kinds of return profiles can be structured The management carries no downside risk as no investments are required from their part	L	Very rare and only used in exceptional cases due to the disadvantageous tax treatment Possible situations include challenging turn-around cases or circumstances in which the sponsor is required to own 100% of the equity	L

* In contrast to the other structures, no fixed return instrument investments are typically made by the financial sponsor

Besides the complexity of the structures and the large number of contractual provisions, the management has to accept the fact that there is no set way of measuring the riskiness of the programs. Typically, only upside and downside scenarios and their implications on the management returns are shown by the sponsor. Even here private equity houses have different approaches and the scenarios are likely to differ considerably from one sponsor to another. Often more time is spent on the various upside cases and the potentially enormous returns play a big role in attracting executives to portfolio companies. Because of being less transparent than their public counterparts, private equity portfolio companies can simply offer higher rewards to their managers.

The number of participants in the programs is positively linked to the size of the buyout. In primary buyouts, investments equal to one to two annual salaries are typically required from top managers, whereas in secondary buyouts the managers' proceeds from the first buyout play a key role. While negotiating over the terms of the program the management's position varies considerably according to the competitive situation of the deal and the team's importance for the company. Secondary buyouts generally entail tougher negotiations as the management has proven to be a high performing team and has gained in experience. They are also likely to be more demanding and conservative with their significant financial investments.

The following relationships were observed in the quantitative analysis. The absolute payoffs to managers were found to increase with company value. Fund professionals argued that it is easier to be generous in large transactions as the impact on your own returns is less significant. Indeed, despite the higher absolute payoffs the share of equity proceeds that is allocated to the management proved to be smaller in large transactions. Furthermore, a clear difference in the equity proceeds distributions was found between primary and secondary buyouts. Secondary buyout managements are assigned a higher and more consistent fraction of the exit proceeds, which is a logical consequence of their higher initial investments combined with more conservative return profiles. According to the practitioners, the overall return expectations of private equity funds have declined with the maturing of the industry. This has had a direct impact on management ownership programs and moved the threshold level after which the management is better off than the sponsor to the left. For instance, if a fund used to set its ratchets at 2.5 to 3 times money at the beginning of the decade, the point is likely to be closer to two nowadays.

When determining the appropriate level of management payoffs, there seem to be two distinct approaches. Some funds concentrate on envy ratios, whereas others look at the absolute payoffs to the management in different scenarios. In any case, the management makes significantly higher returns if the targets of the business plan are achieved, which was also clearly evident in the envy ratios of the numeric transaction data. The tightening regulation, namely the introduction of the Sarbanes-Oxley Act, has made public-to-private transactions considerably more frequent in the U.S., as the granting of options has become more difficult on the public side. According to the practitioners, management returns have increased significantly along the years due to the tightened competition in the industry. Whether the increasing frequency of public-to-private transactions and dominance of auction processes has had a significant impact on management returns would be an interesting area for future research. One could also analyze if there are regional differences in how much of the value increase is shared with the management as U.S. houses have a reputation of being more generous than European funds.

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Appendices

APPENDIX 1: SAMPLE TERM SHEET

SAMPLE Term Sheet

Management Participation XYZ Transaction

The substantial aspects of the management participation upon acquisition of the XYZ Group by the financial investor are outlined hereinafter.

1.	**Participation in LuxCo**	• The Managers of XYZ Group (hereinafter referred to as the "**Managers**") or family partnerships controlled by them participating in the participation program acquire together with the financial investors (hereinafter referred to as "**FI**") up to a total of [•] % of the shareholders' rights in the NewCo (hereinafter referred to as "**Management Participation**"). The NewCo acquires 100 % of the shares in XYZ ("**Target**"). • [•] % of the Management Participation can be withdrawn from the management if the FI does not reach the IRR of [≥ 25] % in an exit scenario by exercise of a call right (ratchet). The FI calculates the IRR as detailed in **Schedule 1**. • The participation amount shall be deemed fully diluted, this is especially in consideration of a possible equity kicker within the framework of a mezzanine financing. The acquisition of the management participation by the Manager shall be designed ideally for tax purposes. • The [•] % of the Management Participation shall be distributed among the Management as follows: – CEO [•] % – CFO [•] % – other Managers [•] % The final distribution shall take place among the Managers themselves. • The [•] % of the Management Participation shall be distributed among the Managers, whereas Mr. CEO shall basically be distributed a higher share than the other Managers. • Shares of the Managers in the NewCo shall have the same rights, especially voting and dividends rights, as the shares of the financial investors. • The NewCo shall bear all arising costs for advisors, structuring and financing within the framework of the

		Management Participation/of the MBO.
2.	**Financing of the NewCo**	• The Managers participate in the NewCo on the basis of the same equity valuation as of the FI. • Additionally, the FI will grant the NewCo a shareholder loan amounting to at least EUR [•]. The interest rate of this shareholder loan shall not exceed [•] % p.a. • Furthermore the NewCo shall be financed by borrowed capital from banks. • The final acquisition structure including possible tax implications shall be agreed with the Managers. This implies that the parties will work towards a tax ideal structure, in order to especially guarantee the tax-deductibility of interest payments.
3.	**Amount of the Investment:**	• The Managers' investment amounts to EUR [•] for 1 % of the nominal capital of the NewCo. Consequently, the total investment of the Manager amounts to EUR [•] (hereinafter referred to as "**Total Investment**"). • Money gaps of the Manager upon payment of the Total Investment shall be bridged by the FI's loans or extension of the investment. FI undertakes to provide the Manager upon request with borrowed capital of the Total Investment amounting to at least [75 %] at a maximum interest rate of [5.5 %]. Such loan including interest shall be due for payment from exit proceeds only upon exit. • [TBD: Recourse]
4.	**Form of the Participation:**	• The Management Participation shall be held directly by the Managers or at a Manager's choice by a family partnership controlled by the Manager, i.e. without an intermediary trustee.
5.	**Guarantees in the Participation Agreement:**	• [The Managers shall not issue any guarantees or warranties to the FI or the NewCo within the scope of the Participation Agreement.] **OR** • The Managers shall issue the following guarantees to the FI - the business plan was set up in the best knowledge of the Managers with the diligence of a prudent managing director - the Managers did not receive incentives in connection

	with the sale, unless disclosed - temporal limitation of the claim resulting from the guarantees - limitation of the amount of the liability from the guarantees
6. Drag Along Right:	• In case of a change of control sale of shares in the NewCo by FI to a third party (change of control), FI shall have the right vis-à-vis the Managers to request a pro rata drag along, in case the third party offers the same conditions to all parties and the price offered by the third party corresponds at least with the fair market value of the shares. • The Managers' drag along liability does not exist - in case of a syndication of the shares of the FI in the NewCo to other FIs within the framework of the acquisition or at a later point of time; or - in case of a participation of additional managers within the framework of the Management Participation.
7. Tag-Along-Right:	• In case of a sale of shares in the NewCo by FI to a third party, the managers shall have the right vis-à-vis the FI to request a pro rata tag along; in this case, the FI has to ensure that the third party offers the same conditions to all parties and the price offered by the third party corresponds at least with the fair market value of the shares. • In case - of a change of control sale of shares in the NewCo by the FI to a third party (change of control); or - of a sale of [25] % of the shares in NewCo by the FI to a competing strategic investor (especially the company •), the Managers shall have the right vis-à-vis the FI to a total tag-along; in this case, the FI has to ensure that the third party offers the same conditions to all parties and the price offered by the third party corresponds at least with the fair market value of the shares.
8. Exit IPO:	• In case of an IPO the Managers shall be entitled to a pro rata tag along right subject to an opposed legal lock up period. • After an IPO, the Managers are free to dispose of their participation.

9. Call-Option FI:	• FI shall be entitled vis-à-vis the Managers or their family partnerships a call option amounting to 100 % on the Management Participation; however, the call option can only be exercised upon occurrence of the following events: (1) effective termination of the employment agreement with the Manager with XYZ or with a company affiliated with XYZ, unless there is no extraordinary termination reason the Manager is responsible for; (2) termination of the employment agreement or a company affiliated with XYZ due to a the temporal limitation and the employment agreement was not prolonged for good cause, the Manager is responsible for; • The FI shall be entitled to a call option amounting to 100 % vis-à-vis the Manager or the family partnership; however the call option may only be executed after the occurrence of the following events and after four years following the closing of the transaction: (3) death of the Manager (4) permanent disability of the Manager (5) termination of the employment agreement with XYZ or with a company affiliated with XYZ by termination, unless in case of a situation stated in no. 9 (1); (6) termination of the employment agreement with XYZ or a company affiliated with XYZ due to the temporal limitation and the employment agreement was not prolonged for good cause, the Manager is responsible for in accordance with no. 9 (2); (7) termination of an employment agreement with XYZ or a company affiliated with XYZ due to retirement; • The parties agree that in case of an additional employment agreement instead of the existing employment, advisory agreement or an affiliation relationship with an existing or future company of the XYZ group that an option case shall not exist.
10. Ratchet:	• In case the financial investors do not achieve an IRR of at least [•] %, the financial investors shall have a call right vis-à-vis the Managers regarding 100 % of their shares.
11. Put-Option Manager:	• The Managers or the respective heirs shall be entitled to a put option regarding 100 % of the Management Participation vis-à-vis the FI. The put option can be exercised upon

	occurrence of the following events: (1) death of the Manager; (2) permanent disability of the Manager; or (3) In case of a termination of the employment agreement or the affiliation relationship with XYZ or with a company affiliated with XYZ, unless a termination reason exists the Manager is responsible for; or (4) in case of a termination of the employment agreement or the affiliation relationship with XYZ or with a company affiliated with XYZ, as long as an exceptional termination reason exists for the Manager, which XYZ or the FI is responsible for; or (5) the sale of substantial company's assets of the business of the XYZ group (lower level sale); or • Merger of NewCo or XYZ with a competitor of XYZ or contribution of NewCo or XYZ into a holding which holds or will hold comparable or competitive companies.
12. Pre-Emption Right Manager:	• As far as the FI purchased due to the exercise of a call option from such manager a share in NewCo and did not sell such share within three months after the exercise of a call option to a new manager, the remaining Managers shall be entitled to a call right within three months after the respective 3 months' period each in the proportion of their participation vis-à-vis the FI with respect to the Management Participation purchased by the FI and not given back to a new manager.
13. Purchase Prices:	• The purchase price of the Management Participation is basically the fair market value at the time of the exercise of an option. • In case of a situation in accordance with no. 9 (1) or 9 (2) or a ratchet in accordance with no. 10, the purchase price of the Management Participation shall be the lower of acquisition costs of the Management Participation plus [2 % p.a above the Three-Months'-Euribor] at the point of time of the exercise of the option, and the fair market value of the participation. • In case of a situation in accordance with no. 9 (3) or (4) or no. 11 (1) or (2), the purchase price of the Management Participation shall be the higher of acquisition costs of the Management Participation plus [2 % p.a above the Three-Months'-Euribor] at the point of time of the exercise of the

	option, and the fair market value of the participation. • The purchase price of the Management Participation shall be due for payment within 2 weeks after the exercise of an option. An overdue amount shall bear interest with the interest rate applicable in accordance with Sec. 288 German Civil Code.
14. Fair Market Value:	• The fair market value at the point of time of the exercise of an option shall be determined by the parties and if they cannot agree on such value by an arbitrator. The costs for the evaluation of the Management Participation shall be borne by the FI. • The fair market value of the Management Participation shall be determined at the time of the exercise of the option as follows: EBITDA x [Initial Multiple] - Net Debt
15. Corporate Actions:	• Possibly necessary contributions to capital shall be borne by FI or another financial investor in the same proportion as between the financing of the nominal capital and shareholder loans. • The Managers shall be entitled to exercise their pro rata purchase right attributable to them in case of possible following equity financing: however, the Managers shall neither be obliged to exercise pre-emptive rights, nor to any subsequent payments. • Capital increases or the contribution of shareholder loans of the financial investors shall only be executed for new shares in NewCo only at fair market value.
16. Profit Distribution:	• With the exception of shareholder loans plus interest, the FI is not entitled to any liquidation preference.
17. Advisory Board / Supervisory Board:	• The parties plan to install an advisory board for NewCo. Purpose of such advisory board (of [•]) shall not be the supervision of the business of the management but serving for the sole purpose of involving persons with know how and with contacts of relevant businesses of XYZ into the XYZ group. The Managers shall be entitled to delegate at least [one] person into a possible advisory board.

	• The Managers shall be entitled to delegate [•] person[s] for a possible supervisory board.
18. Rules of Procedure / Rules of Association:	• The creation of the rules of procedure shall be in close cooperation with the Managers and while protecting the discretionary powers of the existing Managers.
19. Control of the Management:	• Rules of procedure shall be agreed upon for the management. These rules shall contain requirements of agreement for the execution of certain legal transactions of substantial importance, without restricting the management in functional measures.
20. Employment Agreements:	• The Managers agree that the existing employment agreements are to be amended. The new employment agreements shall take into consideration the following items: - fixed remuneration - ratio fixed remuneration / bonus - contract period [in correspondence with vesting schedule] - [post-contractual non-competition clause] • [Miscellaneous]
21. Miscellaneous:	• Language of the agreement shall be German • This agreement shall be subject to German legislation • Maturity of the agreement shall be the earlier of - IPO of NewCo or XYZ; - at the time when FI holds less than 50 % plus one vote of the shares in NewCo; or - December 31, 20••

APPENDIX 2: ADVISOR QUESTIONNAIRE

1. What kind of Incentive Scheme services do you provide to PE clients?

-
-
-

2. What countries do you cover?

-
-
-

3. Have you done any kinds of studies / research on incentive schemes in PE? YES ☐ NO ☐

4. Do you have any materials on management participation programs (MPPs) that you could send to me? YES ☐ NO ☐

5. Are there big differences in the ways in which PE firms structure their management incentive schemes? YES ☐ NO ☐

6. Do you think that PE firms are better in providing managers with incentives? In which ways? YES ☐ NO ☐

PE firms are better in:

-
-
-

What could public companies learn from private equity firms?

-
-
-

Is the fact that the programs are non-public an important factor to the manager candidates (close to no negative publicity)?

YES ☐
NO ☐

Do PE firms set longer horizons? YES ☐ NO ☐

Average planned holding period

1-2 years	☐
3 years	☐
4 years	☐
5 years	☐
6 years	☐
7- years	☐

7. Return profiles

Can you present some return profile examples on a no-name basis?

What are normal envy-ratio levels in your country (base case management vs. sponsor returns)?

	PRIMARY BUYOUTS		**SECONDARY BUYOUTS**	
		Range		Range
From management's points of view	Weak	☐	Weak	☐
	Average	☐	Average	☐
	Good	☐	Good	☐

In other countries, which? ☐

	PRIMARY BUYOUTS		**SECONDARY BUYOUTS**	
		Range		Range
From management's points of view	Weak	☐	Weak	☐
	Average	☐	Average	☐
	Good	☐	Good	☐

Estimate of envy-ratio distributions in

PRIMARY BUYOUTS	
0-2	
3-4	
5-6	
7-8	
9-10	
11-12	
13-14	
15 ≤	
Totalling	**100 %**

SECONDARY BUYOUTS	
0-2	
3-4	
5-6	
7-8	
9-10	
11-12	
13-14	
15 ≤	
Totalling	**100 %**

8. Instruments und technical structure

What technical structures are used and how common is each type?

Estimate of the popularity of the different alternatives

		If rare, in what situations is the structure used
Direct Participation, basic		
- with synthetic components		
Options		
Phantom stock		
Other synthetic structures		
Bonuses		
Other		
Totalling	**100 %**	

Direct Participation

What are the different ways an **equity kicker** can be structured?

Common equity combined with disproportional shareholder loans between management and sponsor
Common equity combined with disproportional preferred stock between management and sponsor
Common equity
Equity strip + sweet common equity to management
Equity strip + options or performance shares to management
ABC Share Model (some management share classes only payable at exit)

What kind of splits are common

	Mgmt	Sponsor
Common equity		
Shareholders loans		
Preferred stock		
Other		

Does the management get penalized for failure (i.e. at low money multiples for the PE investor)? YES / NO

If YES, is this an important feature for the PE investors YES / NO

Threshold level - Sponsor money multiple below which the management does not fully recover its initial investment

Distributions

Base case **mgmt multiple** when sponsor multiple equals 1?

PRIMARY BUYOUTS	
≤ 0,2	
0,3 - 0,4	
0,5 - 0,6	
0,7 - 0,8	
0,9 - 1,0	
1,1 - 1,2	
1,3 ≤	
Totalling	**100 %**

SECONDARY BUYOUTS	
≤ 0,2	
0,3 - 0,4	
0,5 - 0,6	
0,7 - 0,8	
0,9 - 1,0	
1,1 - 1,2	
1,3 ≤	
Totalling	**100 %**

How many **tiers** (/ people) get to participate?

PRIMARY BUYOUTS	
1	
2	
3	
4	
5	
6	
7 ≤	
Totalling	**100 %**

SECONDARY BUYOUTS	
1	
2	
3	
4	
5	
6	
7 ≤	
Totalling	**100 %**

Investment amounts in annual salaries for top executives?

PRIMARY BUYOUTS	
≤ 0,5	
0,5 - 1	
1,1 - 1,5	
1,6 - 2,0	
2,0 ≤	
Totalling	**100 %**

SECONDARY BUYOUTS	
≤ 0,5	
0,5 - 1	
1,1 - 1,5	
1,6 - 2,0	
2,0 ≤	
Totalling	**100 %**

Vesting schemes

Have you seen positive and negative vesting or even programs with no vesting schedule? Positive / Negative / No vesting schedule

How is the fair market value of the management equity derived?

-
-

What do vesting schemes look like, important components?

-
-
-

Are there big differences in the leaver schemes of various PE firms? YES / NO

Do the firms user similar clauses for Good good leavers / Good leavers / Bad leavers? YES / NO

Please give an example of a common leaver scheme.

*The tables in sheet "**Leaver Schemes**" can be used as a basis, however, any missing leaver cases and their valuations should be added.*

Synthetic components

Are ratchets used? YES / NO and are they common? YES / NO

If used, what are the types of performance targets set? IRR / Money multiples / Sales / EBITDA / Margins / Net Income / Other

How is the riskiness of the programs measured?

-
-

Valuation principles

Do the participating managers buy their shares at the same price as the investor? YES / NO

If NO, using which method are the option-like characteristics of the management participations valued?

Black and Scholes / Binomial / Other:

Overall guidelines

Are there usually any limitations to the managers' payoffs? YES / NO

What kind of limitations are applied, e.g. minimum level or maximum cap of value creation?

-
-

9. Is the tax-treatment of the instruments / the participation plan a primary driver of structuring choices? YES / NO

What kind of an impact does the tax system have on the participation programs in your country?

-
-

10. Do the firms always follow similar guidelines or do they develop MPPs on a case-by-case basis for each portfolio company?

	% of all
Firms applying similar programs each time	
Firms using various structures	

International variation

What elements of management participation programs are a consequence of the legal and tax system in your country?

-
-
-

11. Use of the following clauses in agreements

SCALE: 5 = always
1 = not used

		Triggers
Tag-along		
Drag-along		
Acceleration clauses		

12. Financing of the participations

Ways of financing the management participation?
SCALE: 5 = common
1 = not seen

Private funds	
Bank loan with sponsor assisted negotiations	
Loan from the financial sponsor	
Loan from the target company	

13. Risk of losing money

Regardless of instruments in use, do the managers stand a real risk of losing money?

Always	
In most cases	
In every other case	
Rarely	
Never	

If they stand the risk of losing money, it is usually

All of their investment	
Limited to a certain asset class (e.g. common stock)	
Limited to a maximum amount of	

By which means do they lose money?

The subscription amount for common stock	
The subscription amount for other equity instruments	
The subscription amount for synthetic instruments	
Other types	

14. Negotiation power of the managers

How significantly can the manager affect the conditions of the management partication agreement?

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What details do they successfully bargain about and to what extent are they able to make them more favorable?

Envy-ratio	
Leaver schemes	
Other:	

Do managers negotiate more about their terms in secondary transactions than in primary buyouts? YES / NO

Are they more successful in doing so? YES / NO

What terms can they improve and how significant is the impact?

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15. Is there someone at your firm I could talk to about regional customs and solutions concerning MPP structuring in other countries?

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